United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

77-7183
77-7186

9/28

United States Court of Appeals

FOR THE SECOND CIRCUIT

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & CO.,

Defendant-Appellee.

BRIEF FOR APPELLEE

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TABLE OF CONTENTS

	Page
Preliminary Statement	1
Statement Of Issues For Review	1
Statement Of The Case	2
A. The Nature Of The Case	2
B. The Course Of Proceedings Below	4
The Facts	5
A. The Commencement Of The State Court Action	5
B. The Commencement Of This Action	5
C. The Complaint Herein	6
1. Generally	6
2. The Parties	6
3. The Jurisdictional Allegations	6
4. The "Common" Allegations	6
5. The Trustee's Claims	9
6. SIPC's Claims	10
D. The Complaint In The State Court Action	11
E. The Status Of The State Court Action	11
F. Other Pertinent Matters	12
1. The SEC Action	12
2. The Indictment Against The Weis Officers And The Guilty Pleas	12
3. The "Customer" Actions Against Touche Ross	12
G. The Motion To Dismiss And Judge Wyatt's Decision	13

Page

Argument 14

I. THE DISTRICT COURT CORRECTLY HELD THAT PLAINTIFFS' SECTION 17 "CAUSES OF ACTION" FAIL TO STATE A CLAIM FOR RELIEF, BECAUSE SECTION 17(a) DOES NOT CREATE ANY IMPLIED PRIVATE RIGHT OF ACTION FOR DAMAGES 14

A. The Pertinent Statutes And Rules: The Reporting Requirements Of Section 17(a) And Rule 17a-5, The Other Reporting Sections, And The Express Remedy Provided In Section 18(a) For Misleading Reports 15

1. Section 17(a) and Rule 17a-5 15

2. The Other Reporting Provisions 16

3. Section 18(a) 17

B. Plaintiffs Cannot State A Claim For Relief Under Section 18(a) And Therefore Are Forced To Assert That Section 17(a) Provides An Implied Private Right Of Action For Damages 19

C. In Light Of The Statutory Scheme Of The 1934 Act, And The Express Remedy Provided By Section 18(a), Section 17(a) Does Not Create Any Implied Private Right Of Action For Damages 20

1. The Statutory Scheme Whereby Section 18(a) Provides An Express And Limited Remedy For Misstatements In Section 17(a) Reports Reflects A Congressional Intention That Such Remedy Be Exclusive And That No Additional Remedy Be Implied From Section 17(a) Itself 21

2. The Pertinent Decisions Hold That The Existence Of The Express And Limited Remedy Provided By Section 18(a) Precludes The

Page

Implication Of Any Private Damage Remedy From The Reporting Provisions Such As Section 17(a) 24

3. The Legislative History Of Section 17 Does Not Support An Implied Right Of Action Thereunder 29

4. The Statutory Scheme Thus Demonstrates That The Only Class Provided A Remedy For Reporting Violations Is The Class Of Purchasers And Sellers Referred To In Section 18(a) 30

5. To Imply A Right Of Action Under Section 17(a) Would Be Contrary To The Purposes Of The Purchaser-Seller Requirement Of Section 18(a) 31

6. The Necessity Standard Of *Piper* v. *Chris-Craft Industries, Inc.*, Bars The Implication Of A Private Damage Remedy Under Section 17(a) 33

D. The Contentions Asserted By Plaintiffs And The SEC To Support An Implied Private Right Of Action For Damages Under Section 17(a) Are Without Merit And Must Be Rejected 35

1. Plaintiffs And The SEC Err In Relying Upon Generalities About The Purpose Of Section 17(a) Reports And The Contention That Implication Of A Private Damage Action Would Be Consistent Therewith 36

2. Plaintiffs And The SEC Err In Asserting That Section 18(a) Is Not Relevant To Section 17(a) 38

3. Plaintiffs And The SEC Err In Purporting To Distinguish The Section 13 Decisions 41

Page

4. Plaintiffs Err In Their Reading Of The Legislative History 41

5. Plaintiffs And The SEC Err In Relying Upon *J. I. Case Co.* v. *Borak* 43

6. Plaintiffs And The SEC Err In Relying Upon *Cort* v. *Ash* 47

II. THE DISTRICT COURT CORRECTLY HELD THAT PLAINTIFFS' SECTION 17 "CAUSES OF ACTION" FAIL TO STATE A CLAIM FOR RELIEF, EVEN ASSUMING ARGUENDO THAT THERE COULD BE AN IMPLIED RIGHT OF ACTION FOR DAMAGES UNDER SECTION 17 49

A. Plaintiffs Are Not Members Of The Class Of Public Investors Intended To Be Protected By Section 17(a) 49

1. The Trustee May Not Assert Section 17 Claims In Weis' Behalf 52

2. SIPC May Not Assert Section 17 Claims On Its Own Behalf 55

3. The Trustee May Not Assert Section 17 Claims As A Purported "Bailee" Of Weis' Customers 56

4. SIPC May Not Assert Section 17 Claims As A Purported "Subrogee" Of Weis' Customers 59

B. Section 17(a) Imposes No Duty Upon Accountants Such As Touche Ross 63

C. The Complaint Fails To Allege The Necessary Scienter On The Part Of Touche Ross 64

III. THE DISTRICT COURT CORRECTLY HELD THAT THERE IS NO PENDENT JURISDICTION OVER PLAINTIFFS' COMMON LAW "CAUSES OF ACTION" 68

Page

IV. THE DISTRICT COURT CORRECTLY HELD THAT IT HAS NO BANKRUPTCY JURISDICTION OVER THE TRUSTEE'S COMMON LAW "CAUSES OF ACTION" 69

A. Section 23 Of The Bankruptcy Act, Which Is Incorporated Into SIPA By Section 6(c)(1) Thereof, Controls Here And Operates To Deprive The District Court Of Jurisdiction 70

1. Section 23 Of The Bankruptcy Act 70

2. Section 6(c)(1) Of SIPA, And Its Incorporation Of Section 23 By Reference To Section 102 Of The Bankruptcy Act 71

3. The Unavailability In A SIPA Liquidation Of The Broad Plenary Jurisdiction Exercised Under Section 2a(7) Of The Bankruptcy Act In Chapter X Reorganizations 74

4. The Effect Here Of Section 23 78

B. Sections 5(b)(2) And 6(b)(1) Of SIPA Do Not Provide Jurisdiction For The Trustee's Common Law "Causes Of Action", And There Is No "Additive Pattern" Of Jurisdiction 79

1. Section 5(b)(2) 79

2. Section 6(b)(1) 83

3. The Non-Existence Of An "Additive Pattern" Of Jurisdiction 84

C. Section 115 Of The Bankruptcy Act Does Not Provide Jurisdiction For The Trustee's Common Law "Causes Of Action" 86

D. Touche Ross Did Not Consent To Plenary Jurisdiction Here By Filing Proofs Of Claim 93

1. The Proofs Of Claim Do Not Confer Jurisdiction In This Plenary Action 93

Page

2. The Proofs Of Claim Would Not Confer Jurisdiction Even In A Summary Proceeding 97

V. If The Order Of The District Court Is Reversed In Any Respect, This Action Should Be Stayed Pending Determination Of The State Court Action 101

Conclusion 104

TABLE OF AUTHORITIES

CASES:

Page

Abrahamson v. *Fleschner*, ___ F.2d ___, CCH Fed.Sec.L. Rep. ¶ 95,889 (2d Cir. 1977), *rehearing granted* (April 15, 1977) 20, 22, 32, 47

Aldinger v. *Howard*, 427 U.S. 1 (1976) 69

Alexander v. *Hillman*, 296 U.S. 222 (1935) 100

Almenares v. *Wyman*, 453 F.2d 1075 (2d Cir. 1971), *cert. denied*, 405 U.S. 944 (1972) 69

Baldwin v. *Hill*, 315 F.2d 738 (6th Cir. 1963) 58

Bancroft v. *Indemnity Ins. Co.*, 203 F.Supp. 49 (W.D. La.), *aff'd*, 309 F.2d 959 (5th Cir. 1962) 100-101

Bardes v. *Hawarden Bank*, 178 U.S. 524 (1900) ... 71, 75, 83

Barlas v. *Bear, Stearns & Co.*, CCH Fed.Sec.L.Rep. ¶ 91,674 (N.D. Ill. 1966) 64

Beacon Theatres v. *Westover*, 359 U.S. 500 (1959) 98

In re Beasly-Gilbert's, Inc., 285 F.Supp. 359 (S.D. Ohio 1968) 98-99

In re Behring & Behring, 445 F.2d 1096 (5th Cir.), *cert. denied*, 404 U.S. 991 (1971) 98-100

Bio-Medical Sciences, Inc. v. *Weinstein*, 407 F.Supp. 970 (S.D.N.Y. 1976) 33

Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975) 15, 23-24, 25, 31-32, 35, 40, 54

Brummer v. *Rosenberg*, CCH Fed.Sec.L.Rep. ¶ 92,341 (S.D.N.Y. 1969) 102-103

Bryan v. *Bernheimer*, 181 U.S. 188 (1901) 75

Page

Buttrey v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969) 53

In re Caesar's Palace Securities Litigation, 360 F.Supp. 366 (S.D.N.Y. 1973) 28-29

Caldwell v. *Craighead*, 432 F.2d 213 (6th Cir. 1970).... 101

Caplin v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972) 57

In re Carnell Constr. Corp., 424 F.2d 296 (3d Cir.), *cert. denied*, 400 U.S. 828 (1970) 98

In re Chicago Express, Inc., 332 F.2d 276 (2d Cir.), 1939) 88

Chase Nat'l Bank v. *Lyford*, 147 F.2d 273 (2d Cir. 1945) 94, 96, 99

Cherno v. *Engine Air Service, Inc.*, 330 F.2d 191 (2d Cir. 1964) 99, 101

In Re Chicago Express, Inc., 332 F.2d 276 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964) 88

Cline v. *Kaplan*, 323 U.S. 97 (1944) 80

Cole v. *Schlenley Industries, Inc.*, ___ F.2d ___, Slip Op. 5853 (2d Cir. Sept. 9, 1977) 69

Collins v. *PBW Stock Exchange, Inc.*, 408 F.Supp. 1344 (E.D. Pa. 1976) 53

Columbia Foundry Co. v. *Lochner*, 179 F.2d 630 (4th Cir. 1950) 98

Continental Casualty Co. v. *White*, 269 F.2d 213 (4th Cir. 1959) 97

Continental Illinois Nat'l Bank & Trust v. *Chicago, R.I. & Pac. Ry. Co.*, 294 U.S. 648 (1935) 81

Page

Cort v. *Ash*, 422 U.S. 66 (1975) 38, 43, 47-49

In re Cuyahoga Finance Co., 136 F.2d 18 (6th Cir. 1943) 89

Daniel v. *Guaranty Trust Co.*, 285 U.S. 154 (1932) 99

Detroit Trust Co. v. *Pontiac Savings Bank*, 196 Fed. 29 (6th Cir. 1912), *aff'd*, 237 U.S. 186 (1915) 95

DeWitt v. *American Stock Transfer Co.*, CCH Fed.Sec. L.Rep. ¶ 96,089 (S.D.N.Y. 1977) 28, 41

Drasner v. *Thomson Mckinnon Securities, Inc.*, CCH Fed.Sec.L.Rep. ¶ 96,080 (S.D.N.Y. 1977) 64

Duda v. *Sterling Mfg. Co.*, 178 F.2d 428 (8th Cir. 1949) 81

duPont v. *Wyly*, 61 F.R.D. 615 (D. Del. 1973) 18, 28

In re Eakin, 154 F.2d 717 (2d Cir. 1946) 81

In re Equity Funding Corp. Of America Securities Litigation, 416 F.Supp. 161 (C. D. Cal. 1976) 28, 44, 63,64

Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976) 8, 15, 64-68

Exchange Nat'l Bank v. *Touche Ross & Co.*, (S.D.N.Y. 75 Civ. 916) 42

Exchange Nat'l Bank v. *Wyatt*, 517 F.2d 453 (2d Cir. 1975) 73, 78

In re Farrell Publishing Corp., 130 F.Supp. 449 (S.D.N.Y. 1955) 97-99

In re Federal Facilities Realty Trust, 220 F.2d 495 (7th Cir. 1955) 89-90

H. L. Federman & Co. v. *Greenberg*, 405 F.Supp. 1332 (S.D.N.Y. 1975) 68

Finkelstein v. *Wolf*, CCH Fed.Sec.L.Rep. ¶ 94,885 (S.D. N.Y. 1974) 102

Page

First National Bank v. *Title & Trust Co.*, 198 U.S. 280 (1905) 75

Fisher v. *Kletz*, 266 F.Supp. 181 (S.D.N.Y. 1967) 100-101

Giffin v. *Vought*, 175 F.2d 186 (2d Cir. 1949) 98

Gill v. *Phillips*, 337 F.2d 258 (5th Cir. 1964) 98

Gins v. *Mauser Plumbing Supply Co.*, 148 F.2d 974 (2d Cir. 1945) 95

Goldberg v. *Touche Ross & Co.*, CCH Fed.Sec.L.Rep. ¶ 95,759 (S.D.N.Y. 1976) 100

Green v. *Gage*, 186 F.2d 984 (5th Cir. 1951) 95

Halpert v. *Engine Air Service*, 116 F.Supp. 13 (E.D. N.Y. 1953) 95

Harrison v. *Chamberlin*, 271 U.S. 191 (1962) 80-81

In re Herz Importing Corp., 349 F.Supp. 1106 (S.D. N.Y. 1972) 97

Hoover v. *Allen*, 241 F.Supp. 213 (S.D.N.Y. 1965) 33

In re Ira Haupt & Co., 289 F.Supp. 966 (S.D.N.Y. 1968) 97

Iroquois Industries, Inc. v. *Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970) 34-35

J. I. Case Co. v. *Borak*, 377 U.S. 426 (1964) 20, 43-47

Kaminsky v. *Abrams*, 281 F.Supp. 501 (S.D.N.Y. 1968) 29

Katchen v. *Landy*, 336 F.2d 535 (10th Cir. 1964), *aff'd* 382 U.S. 323 (1966) 94, 98-99

	Page
Kavit v. *A. L. Stamm & Co.*, 491 F.2d 1176 (2d Cir. 1974)	68
Kelley v. *Gill*, 245 U.S. 116 (1917)	80
King v. *Sharp*, 63 F.R.D. 60 (N.D. Texas 1974)	57
Klein v. *Walston & Co.*, 432 F.2d 936 (2d Cir. 1970)	102
Kroese v. *Crawford*, CCH Fed.Sec.L.Rep. ¶ 91,262 (S.D. N.Y. 1963)	29, 41
Landy v. *Federal Deposit Ins. Corp.*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974)	11
Lank v. *New York Stock Exchange*, 548 F.2d 61 (2d Cir. 1977)	33, 37, 38, 50-56, 58, 59
Levy v. *Johnson*, CCH Fed.Sec.L.Rep. ¶ 95,899 (S.D. N.Y. 1977)	28
Locke v. *Bd. of Public Instruction*, 499 F.2d 359 (5th Cir. 1974)	101
In re Los Angeles Trust Deed & Mtge. Exchange, 464 F.2d 1136 (9th Cir.), *cert. denied*, 409 U.S. 1064 (1972)	98-99
Magidson v. *Duggan*, 180 F.2d 473 (8th Cir.), *cert. denied* 339 U.S. 965 (1950)	90
In re Majestic Radio and Television Corp., 227 F.2d 152 (7th Cir. 1955), *cert. denied*, 350 U.S. 995 (1956)	99-100
Mar-Tex Realization Corp. v. *Wolfson*, 145 F.2d 360 (2d Cir. 1944)	81
Massachusetts v. *Westcott*, ___ U.S. ___, 45 U.S.L.W. 4503 (1977)	11
May v. *Moss*, 194 F.2d 133 (8th Cir.), *cert. denied*, 343 U.S. 952 (1952)	95

Page

McLaughlin v. *Campbell*, 410 F.Supp. 1321 (D. Mass. 1976) 28

Meer v. *United Brands Co.*, CCH Fed.Sec.L.Rep. ¶95,648 (S.D.N.Y. 1976) 18, 27, 31

M'Eldowney v. *Card*, 193 Fed.475 (E.D. Tenn. 1911).. 101

Meyer v. *United States*, 175 F.2d 45 (2d Cir. 1949) 61

Miller v. *New York Produce Exchange*, 550 F.2d 762 (2d Cir. 1977) 54

Mottolese v. *Kaufman*, 176 F.2d 301 (2d Cir. 1949) ...101-102

Myers v. *American Leisure Time Enterprises, Inc.*, 402 F.Supp. 213 (S.D.N.Y. 1975), *aff'd by oral opinion*, 538 F.2d 312 (2d Cir. 1976) 18, 27-28

National Railroad Passenger Corp. v. *National Ass'n of Railroad Passengers*, 414 U.S. 453 (1974) 21-23, 25, 38, 44, 62

New York Stock Exchange v. *Sloan*, 394 F.Supp. 1303 (S.D.N.Y. 1975) 42

Nortex Trading Corp. v. *Newfield*, 311 F.2d 163 (2d Cir. 1962) 99

In re Oliver, 127 F.Supp. 842 (D. Kan. 1955) 81

In re Paramount Publix Corp., 7 F.Supp. 988 (S.D.N.Y. 1934) 88

Paskowski v. *Paskowski*, 361 F.Supp. 981 (E.D.N.Y. 1973) 102

In re Penn Central Securities Litigation, 347 F.Supp. 1327 (E.D. Pa. 1972), *decision as to Section 13(a) adhered to on reargument*, 357 F.Supp. 869 (E.D. Pa. 1973), *aff'd*, 494 F.2d 528 (3d Cir. 1974) 18, 26-29, 41, 43

Page

Peters v. *Lines*, 275 F.2d 919 (9th Cir. 1960) 97-98

In re Petroleum Corp. of America, 417 F.2d 929 (8th Cir. 1969) 57

Phipps v. *Chicago, R.I. & P. Ry. Co.*, 284 Fed. 945 (8th Cir. 1922) 91

Piper v. *Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977) .. 15, 20, 33-35, 37, 43, 45-53, 55, 56

In re Prima Co., 98 F.2d 952 (7th Cir.), *cert. denied*, 305 U.S. 658 (1938) 88-89, 92, 95

In re Prudence Bonds Corp., 75 F.2d 262 (2d Cir. 1935) 81, 87

In re Prudence Co., 82 F.2d 755 (2d Cir.), *cert. denied*, 298 U.S. 685 (1936) 88

Reading Co. v. *Brown*, 391 U.S. 471 (1968) 88

Remington v. *Remington*, 393 F.Supp. 898 (E.D. Pa. 1975) 68-69

Rich v. *Touche Ross & Co.*, 415 F.Supp. 95 (S.D.N.Y. 1976) 13, 25, 49, 67

Rochelle v. *Marine Midland Grace Trust Co.*, 535 F.2d 523 (9th Cir. 1976) 75, 90

Rogers v. *Nat'l Surety Co.*, 116 Neb. 170, 216 N. W. 182 (1927) 62

In re Roman, 23 F.2d 556 (2d Cir. 1928) 81

Rosen v. *Dick*, CCH Fed.Sec.L.Rep. ¶ 94,786 (S.D.N.Y. 1974) 68

Rosenfeld v. *Black*, 445 F.2d 1337 (2d Cir. 1971) 103

Rothstein v. *Seidman & Seidman*, 410 F.Supp. 244 (S.D. N.Y. 1976) 63

Santa Fe Industries, Inc. v. *Green*, ___ *U.S.* ___, 45 U.S. L.W. 4317 (1977) 15, 33, 49, 64

Page

Schumacher v. *Beeler*, 293 U.S. 367 (1934) 71, 94-96

In re Seatrade Corp., 297 F.Supp. 577 (S.D.N.Y. 1969) 99-100

Securities and Exchange Commission v. *Aberdeen Securities Co., Inc.*, 480 F.2d 1121 (3rd Cir.), *cert. denied*, 414 U.S. 1111 (1973) 61

Securities and Exchange Commission v. *Albert & McGuire Securities Co., Inc.*, ___ F.2d ___, CCH Fed.Sec.L. Rep. ¶ 96,129 (3d Cir. 1977) 59

Securities and Exchange Commission v. *Morgan Kennedy & Co., Inc.*, CCH Fed.Sec.L.Rep. ¶ 94,568 (S.D.N.Y. 1974) 72, 73, 77, 82

Securities and Exchange Commission v. *S. J. Salmon & Co.*, 375 F.Supp. 867 (S.D.N.Y. 1974) 61

Securities Investor Protection Corporation v. *Barbour*, 421 U.S. 412 (1975) 22, 38, 44

In re Schafer's Bakeries, 129 F.Supp. 82 (E.D. Mich. 1955) 88

In re Sixty-Seven Wall St. Rest. Corp., 23 F.Supp. 672 (S.D.N.Y. 1938) 88

Slenderella Systems of Berkeley, Inc. v. *Pacific Tel. & Tel.*, 286 F.2d 488 (2d Cir. 1961) 81

Smith v. *Government of Virgin Islands*, 329 F.2d 135 (3d Cir. 1964) 101

In re Standard Gas & Elec. Co., 119 F.2d 658 (3d Cir. 1941) 80-81, 88, 90, 92

Stiefel v. *14th Street & Broadway Realty Corp.*, 48 F.2d 1041 (2d Cir. 1931) 95

In re Supreme Meat Co., 73 F.R.D. 295 (E.D. Mo. 1976) 99

Page

Tamasha Town & Country Club v. *McAlester Constr. Fin. Corp.*, 252 F.Supp. 80 (S.D. Cal. 1966) 81, 94-95

Taubel-Scott-Kitzmiller v. *Fox*, 264 U.S. 426 (1924) 80

Tenenbaum v. *Walter E. Heller & Co.*, 308 F.Supp. 1085 (S.D.N.Y. 1970) 94

Thompson v. *Terminal Shares*, 104 F.2d 1 (8th Cir. 1939) 81

Tilton v. *Model Taxi Corp.*, 112 F.2d 86 (2d Cir. 1940) 92, 95

Toledo Fence & Post Co. v. *Lyons*, 290 Fed. 637 (6th Cir. 1923) 95

United Mine Workers v. *Gibbs*, 383 U.S. 715 (1966) 68

United States v. *Anderson*, 334 F.2d 111 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964) 88

United States v. *Cooper Corp.*, 312 U.S. 600 (1941) 61

United States v. *Tacoma Oriental S. S. Co.*, 86 F.2d 363 (9th Cir. 1936) 88

United States v. *Vargas*, 380 F.Supp. 1162 (E.D.N.Y. 1974) 61

In re V. Loewer's Gambrinus Brewery Co., 141 F.2d 747 (2d Cir. 1944) 88

Vanston Committee v. *Green*, 329 U.S. 156 (1946) 88

Warder v. *Bradley*, 115 F.2d 89 (4th Cir. 1940) 89

Weiner v. *Shearson, Hammill & Co.*, 521 F.2d 817 (9th Cir. 1975) 102

Whitney v. *Wenman*, 198 U.S. 539 (1905) 96

Page

Wilkin v. *Dana T. Pickup & Co.*, 74 Misc.2d 1025, 347 N.Y.S.2d 122 (Sup. Ct. Allegany Co. 1973) 100

William B. Tanner Co., Inc. v. *WIOO, Inc.*, 528 F.2d 262 (3d Cir. 1975) 101

Williams v. *Austrian*, 331 U.S. 642 (1947) 71, 74-76, 83, 85, 89-90

Witmar Salvage Corp. v. *C. W. Blakeslee & Sons, Inc.*, 308 F.Supp. 395 (S.D.N.Y. 1969) 103

In re Wonderbowl, Inc., 456 F.2d 954 (9th Cir. 1972).. 97

Wymard v. *McCloskey & Co.*, 342 F.2d 495 (3rd Cir.), *cert. denied*, 382 U.S. 823 (1965) 95

In re Yale Express Systems, Inc., 362 F.2d 111 (2d Cir. 1966) 88

Zahn v. *International Paper Co.*, 414 U.S. 291 (1973).. 69

STATUTES AND RULES:

Bankruptcy Act (11 U.S.C. §§ 1 *et seq.*)

Section 2a(5), 11 U.S.C. § 11a(5) 84

Section 2a(7), 11 U.S.C. § 11a(7) 6, 69-70, 74-75, 85, 89-91, 93, 96

Section 22, 11 U.S.C. § 45 78

Section 23, 11 U.S.C. § 46 ..... 70-78, 82, 85, 89-95

Section 70(e), 11 U.S.C. § 110(e) 53

Section 75(n), 11 U.S.C. § 203(n) 80

Section 77, 11 U.S.C. § 205 80-81

Section 77B, 48 Stat. 911 ..... 80-81, 87-89, 91-92

Page

Section 82(a), 11 U.S.C. § 402(a) 80
Section 102, 11 U.S.C. § 502 ..... 6, 71-78, 85-86, 89-91
Section 106, 11 U.S.C. § 506 62
Section 111, 11 U.S.C. § 511 80-81
Section 115, 11 U.S.C. § 515 ..... 6, 82, 86-93
Section 117, 11 U.S.C. § 517 78
Section 311, 11 U.S.C. § 711 80-81
Section 411, 11 U.S.C. § 811 80
Section 611, 11 U.S.C. § 1011 80-81

Bankruptcy Rule 122(1) 78

Federal Rules of Evidence Rule 201(d) 11

Judicial Code, 28 U.S.C.:
Section 1331, 28 U.S.C. § 1331 6
Section 1332, 28 U.S.C. § 1332 ..... 6, 70
Section 1334, 28 U.S.C. § 1334 6

Securities Exchange Act of 1934 (15 U.S.C. §§ 78a *et seq.*)
Section 6, 15 U.S.C. § 78f 50, 51, 53
Section 10, 15 U.S.C. § 78j 3, 23, 65
Section 13, 15 U.S.C. § 78m 16-17, 39
Section 14, 15 U.S.C. § 78n 43

Page

Section 15, 15 U.S.C. § 78o 16-17

Section 17, 15 U.S.C. § 78q ..... 15-16, *passim*

Section 18, 15 U.S.C. § 78r ..... 17, *passim*

Section 27, 15 U.S.C. § 78aa 6

Securities and Exchange Commission Rules

Rule 10b-5, 17 C.F.R. § 240.10b-5 ..... 23, 65

Rule 14a-9, 17 C.F.R. § 240.14a-9 43

Rule 17a-5, 17 C.F.R. § 240.17a-5 ..... 16-17, 18, 36-37, 39, 52, 63-64

Securities Investor Protection Act of 1970 (15 U.S.C. §§ 78aaa *et seq.*)

Section 5, 15 U.S.C. § 78eee 69-70, 79, 80-86

Section 6, 15 U.S.C. § 78fff 57, 59-62, 69-73, 77, 79, 83-86, 92

CONGRESSIONAL MATERIALS:

78 Cong. Rec. 2270 (1934) 34

78 Cong. Rec. 2271 (1934) 18

83 Cong. Rec. 8708 (1938) 87

116 Cong. Rec. 39350 (1970) 56

SIPC, *Report of the Special Task Force to Consider Possible Amendments to SIPA*, reprinted in Hearings before the Subcommittee on Consumer Protection and Finance, 94th Cong. 1st Sess. Serial No. 94-56 (1975) 78, 83-84

Page

Hearings before House Jud. Comm. on H.R. 1670, H.R. 3083, H.R. 4311, H.R. 5267 and H.R. 5009, 73d Cong., 1st Sess. (1933) 91

Hearings before a Subcommittee of the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess., (1934).. 18-19

Hearings on H.R. 7852 and H.R. 8720, before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., (1934) 18-19, 29-30

Hearings before a Subcommittee of the House Committee on Int. & For. Comm., 91st Cong., 2d Sess. Serial No. 91-67 (1970) 80

Hearings before a Subcommittee of the Senate Comm. on the Judiciary on H.R. 8046, 75th Cong., 2d Sess. (1937-1938) 89, 93

H.R. 5009, 73d Cong., 1st Sess. 90

H.R. No. 1383, 73d Cong., 2d Sess. (1934) 29

H.R. 13308, 91st Cong., 2d Sess. 80

H.R.18081, 91st Cong., 2d Sess. 80

H.R.18109, 91st Cong., 2d Sess. 80

H.R. 18458, 91st Cong., 2d Sess. 80

H.R. 8064, 94 Cong. 1st Sess. (1975) *reprinted in* Hearings before Subcommittee on Consumer Protection and Finance, H.R. Serial No. 94-56, 94th Cong. 1st Sess. 83-84

H.R. Rep. 91-1613, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Adm. News 5254 ..... 61, 62, 84

Page

S. Doc. No. 185, 73d Cong., 2d Sess. (1934) 29

S. Rep. No. 792, 73rd Cong., 2d Sess. (1934) 29

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TREATISES:

COLLIER ON BANKRUPTCY 62, 73-74, 76-78, 83, 87, 90-91, 95

HOLMES, THE COMMON LAW, LECTURES V-VI (1963 ED.) 57

MOORE'S FEDERAL PRACTICE 11, 74

5 N.Y. JURISPRUDENCE, Bailment (1975 REV.) 57

PROSSER, LAW OF TORTS (4TH ED. 1971) 57

1 WEINSTEIN'S EVIDENCE ¶ 200 [03] 46

ARTICLES:

Ferguson, *The Consensual Basis of Subject-Matter Jurisdiction in Matters of Bankruptcy: Fact and Fiction*, 14 Rutgers L. Rev. 491 (1959) 98

Friendly, *Some Comments on the Corporate Reorganization Act*, 48 Harv. L. Rev. 39 (1934) 90

Page

Guttman, *Broker-Dealer Bankruptcies*, 48 N.Y.U.L. Rev. 887 (1973) 61-62

Weinstein, *A Time of Travail and Challenge*, 44 CPA J. 29 (Dec. 1974) 37

MISCELLANEOUS:

SIPC First Annual Report (1971) 78, 85

SIPC Second Annual Report (1972) 78, 85

BRIEF FOR APPELLEE

Preliminary Statement

Defendant-appellee Touche Ross & Co. ("Touche Ross") submits this brief on the appeals by plaintiffs-appellants Edward S. Redington ("the Trustee"), as Trustee for the liquidation of the business of Weis Securities, Inc. ("Weis"), and Securities Investor Protection Corporation ("SIPC"). The Trustee and SIPC (collectively referred to as "plaintiffs") appeal from Judge Inzer B. Wyatt's order and judgment (413a-414a[1]) in the District Court dismissing their complaint (5a-91a) because (i) plaintiffs' purported federal claims, being based upon Section 17 of the Securities Exchange Act of 1934 (the "1934 Act"), fail to state a claim upon which relief can be granted, and (ii) the District Court lacks subject matter jurisdiction over plaintiffs' other, common law claims. Judge Wyatt's opinion (391a-412a) — which the Trustee inaccurately describes as being based only on "lack of subject matter jurisdiction" (Trustee Br. 1, 12) — is reported at 428 F.Supp. 483.

As Judge Wyatt recognized below, the arguments asserted here in plaintiffs' separate briefs, and in the *amicus curiae* brief submitted by the Securities and Exchange Commission (the "SEC") in support of SIPC's Section 17 claims, are totally lacking in merit and must be rejected. Judge Wyatt's order is correct and should be affirmed in all respects.

Statement of Issues for Review

1. (a) Did the District Court correctly hold that, where Section 18(a) of the 1934 Act provides an express

[1] Page references followed by "a" are to the Joint Appendix.

remedy for misstatements in reports required by Section 17(a) thereof, Section 17(a) does not create an implied private right of action for damages allegedly resulting from such misstatements, and that plaintiffs' claims based upon Section 17(a) fail to state a claim for relief?

(b) Did the District Court correctly hold that, even assuming *arguendo* that there could be an implied private right of action for damages under Section 17(a), plaintiffs still fail to state a claim for relief, because (i) they are not members of the class intended to be protected by Section 17(a), (ii) Section 17(a) imposes no duties upon accountants such as Touche Ross, and (iii) the complaint fails to allege *scienter*?

2. Did the District Court correctly hold that Section 23 of the Bankruptcy Act and its jurisdictional limitations are controlling here, and that under Section 23 there is no bankruptcy jurisdiction over the Trustee's common law claims of negligence, malpractice, gross negligence, breach of contract and breach of warranty?

3. If the District Court is reversed in any respect, should not this action be stayed pending determination of an earlier-commenced and almost identical State Court action brought by plaintiffs against Touche Ross, particularly in light of the essentially common law character of plaintiffs' claims?

Statement of the Case

A. The Nature Of The Case.

This action is the second of two separate, but practically identical, actions commenced by plaintiffs against Touche Ross. Plaintiffs' first action (the "State Court Action"), which is presently proceeding, was commenced in the New York State courts almost a year before this action and involves exactly the same parties and seeks exactly the same relief as does this action. Contrary to

representations made by plaintiffs on this appeal, the State Court Action is in the active discovery stage.

Both the State Court Action and this action arise out of the liquidation of Weis, a now defunct brokerage firm, under the Securities Investor Protection Act of 1970 ("SIPA"), and seek to impose liability of over $65,000,000 upon Touche Ross, a firm of certified public accountants, by reason of its work in connection with certain financial statements of Weis for periods ending approximately a year before the Weis collapse.

As plaintiffs recognized by first commencing the State Court Action, their claims against Touche Ross are essentially state-created, common law claims of accountant's negligence, malpractice, breach of contract and breach of warranty, and plaintiffs have expressly alleged those common law claims not only in the State Court Action but also again in this action. In this action, however, plaintiffs also have sought to create the appearance of additional, federally created claims by the well-worn tactic of simply alleging that the conduct of Touche Ross which gives rise to their common law claims also violated the 1934 Act. Since plaintiffs were not purchasers or sellers of securities and could not rely upon the provisions of the 1934 Act (*e.g.*, Section 10(b) or Section 18(a)) typically asserted as the basis of claims thereunder, they were forced to allege that Touche Ross had violated Section 17(a) of the 1934 Act, and to assert the clearly erroneous view that Section 17(a) itself gives each of them an implied private federal right of action for damages for such violation.

The *primary issue* on this appeal is whether plaintiffs have an implied private right of action for damages under Section 17(a). If (as Judge Wyatt correctly held below) they do not, pendent jurisdiction over their basic, common law claims is necessarily lacking and a *secondary issue* is raised — *viz.*, whether there is any other basis for subject matter jurisdiction over the Trustee's common law

claims.[2] The Trustee asserted below and maintains here (despite Judge Wyatt's correct rejection of his assertions) that the District Court has bankruptcy jurisdiction over those claims.

It is Touche Ross' position that Judge Wyatt correctly rejected plaintiffs' positions on both the primary and secondary issues and properly dismissed this action, and that this Court must affirm. However, should this Court hold that any part of plaintiffs' action is viable, the existence of the State Court Action and the essentially common law character of plaintiffs' claims raise a *tertiary issue* which was asserted below and which should now be decided by this Court. That is whether, particularly in this day of over-crowded court dockets, and overburdened and too-limited judicial resources, plaintiffs should be permitted to proceed at the same time with both this action and the almost identical State Court Action. Touche Ross' position is that they should not and that this action should be stayed pending final determination of the State Court Action.

B. The Course Of Proceedings Below.

This action was commenced on April 30, 1976 (1a, 131a). On September 15, 1976, and prior to answer, Touche Ross moved to dismiss the action for failure to state a claim for relief and for lack of subject matter jurisdiction, and for related relief (2a, 127a-128a). On March 1, 1977, Judge Wyatt issued his opinion holding that plaintiffs' Section 17 claims fail to state a claim for relief and that the District Court is without subject matter jurisdiction over plaintiffs' common law claims (3a, 391a-412a), and on March 15, 1977, signed an order dismissing the complaint and this action (3a, 413a-414a). Plaintiffs filed their separate notices of appeal on April 13 and April 14, 1977 (3a, 4a, 415a-418a).

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[2] SIPC contended below, but here abandons the contention (which Judge Wyatt correctly rejected), that diversity jurisdiction exists with respect to its common law claims (SIPC Br. 5 n.).

The Facts

There are two critical facts here. First, plaintiffs' purported federal claims (*viz.*, the Trustee's first, and SIPC's first through fourth, so-called "causes of action") are based solely on Section 17(a) of the 1934 Act — an important fact because Section 17(a) provides no private right of action for damages and plaintiffs' claims based thereon consequently fail to state a claim for relief. Second, plaintiffs' other claims (*viz.*, the Trustee's second through sixth, and SIPC's fifth through eighth, "causes of action") are concededly common law claims — an important fact because there is no federal subject matter jurisdiction over those claims. The context of those critical facts is not adequately set forth in the fragmented and argumentative factual statements contained in plaintiffs' briefs and is set forth here.

A. The Commencement Of The State Court Action.

On July 3, 1975, plaintiffs commenced the State Court Action in the Supreme Court of the State of New York, County of New York, under the title (which is the same as the title of this action) *Edward S. Redington, as Trustee for the liquidation of the business of Weis Securities, Inc., and Securities Investor Protection Corporation* v. *Touche Ross & Co.* (Index No. 13996/76[3]) (131a, 137a-138a). The parties to the State Court Action are the same as the parties to this action and, as shown more fully hereinafter, the complaint in the State Court Action (139a-166a) asserts identical factual allegations and almost identical claims, and seeks identical relief, as does the complaint here.

B. The Commencement Of This Action.

On April 30, 1976, almost ten months after they had commenced the State Court Action, plaintiffs commenced this action (1a, 5a-91a, 131a).

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[3] As Judge Wyatt noted, the State Court Action "has a 1976 number because the first paper filed in the action was in 1976" (393a).

C. The Complaint Herein.

1. GENERALLY. — The complaint contains 14 separate so-called "causes of action", the first six asserted by the Trustee and the other eight asserted by SIPC.

2. THE PARTIES. — The Trustee was allegedly "duly appointed" by order of the District Court dated May 30, 1973 (Comp. ¶5[4]). SIPC is alleged to be "a non-profit membership corporation created by and organized under" SIPA, and Weis allegedly was "a member of SIPC" (Comp. ¶6). Touche Ross is alleged to be "a partnership of certified public accountants" which was engaged by Weis in 1969 as "its independent certified public accounting firm" and continued to act as such "until about M[illegible] 1973, when the forced liquidation of Weis commenced" (Comp. ¶7).

3. THE JURISDICTIONAL ALLEGATIONS. — After alleging that this action "arises under" Section 17 of the 1934 Act, SIPA and "the common law" (Comp. ¶1), the complaint alleges various bases for federal subject matter jurisdiction. Jurisdiction of the Trustee's claims is alleged to exist by reason of Section 27 of the 1934 Act, Section 6 of SIPA, Sections 2(a)(7), 102 and 115 of the Bankruptcy Act, Sections 1331 and 1334 of the Judicial Code, and principles of pendent jurisdiction (Comp. ¶2). Jurisdiction of SIPC's claims is allegedly based upon Section 27 of the 1934 Act, Sections 1331 and 1332 of the Judicial Code and principles of pendent jurisdiction (Comp. ¶3).

4. THE "COMMON" ALLEGATIONS. — The complaint contains a group of so-called "common" allegations (Comp. ¶¶8-31)which set forth the alleged factual basis for, and are expressly realleged in their entirety in, each of the complaint's 14 "causes of action". As plaintiffs themselves state, the "factual heart of the case is essen-

[4] The reference "Comp." is to the complaint in this action, which is reproduced at 5a-91a.

tially pleaded under the heading 'Common Allegations' " (SIPC Br. 7; Trustee Br. 10, 11; see also 395a).

The "common" allegations assert that Weis was a "broker-dealer in securities" registered with the SEC and a "member" of the New York Stock Exchange (the "Exchange") (Comp. ¶8); that events which had "come to light" in April and May 1973 by reason of "separate investigations by the Exchange and the SEC" resulted in "Weis' forced liquidation under [SIPA]" (Comp. ¶13); and that on May 30, 1973 "the liquidation of Weis was ordered [by the District Court]" (Comp. ¶14).

The "common" allegations also assert that five Weis officers (the "Weis Five") "misstated the financial condition and results of operations of Weis in financial reports prepared at fiscal year-end 1972", in order to "create a false impression that Weis' earnings for the fiscal year ended May 26, 1972 were $1,700,000" whereas "Weis had actually suffered losses . . . in excess of $1,500,000" (Comp. ¶10); that those financial reports "were required to be filed with regulatory authorities pursuant to Section 17 of the 1934 Act" and "were directly or indirectly submitted to Weis, its Board of Directors, the SEC, SIPC, the Exchange, and Weis' customers, creditors, lenders and shareholders" (*id.*); that if "Weis' actual [1972] financial condition . . . [had] been truthfully reported", Weis' forced liquidation in 1973 "would not have become necessary, and most if not all of Weis' assets and its good will as a going concern could have been preserved" (Comp. ¶11); and that even "if a liquidation of Weis had been necessary . . . such liquidation could have occurred at the end of Weis' 1972 fiscal year, when its assets were greater and the aggregate of its liabilities was lower than a year later" (*id.*).

Liability is sought to be imposed upon Touche Ross by reason of its alleged acts and omissions with respect to Weis' financial statements as of May 26, 1972 (Comp.

¶¶19, 24). It is alleged that Touche Ross "knew or should have known" that its engagement "was a requirement of the Exchange" and "was for the benefit both of Weis . . . and of persons other than Weis", and that "its examination of and report on Weis' financial condition were a requirement of Section 17 . . . and the rules and regulations promulgated thereunder" (Comp. ¶¶20, 22); that Touche Ross "purported to conduct an audit of Weis' books and records for the fiscal year ended May 26, 1972" and in connection therewith certified and issued opinions with respect to the financial statements (Comp. ¶¶23, 24); that Touche Ross "knew, should have known and intended" that Weis, its Board of Directors, the SEC, the Exchange, SIPC, customers, creditors, lenders and shareholders "would rely" on its opinion letters and the financial statements for various purposes (Comp. ¶¶25-27); and that Touche Ross "breached and failed to perform its agreement and obligation to render auditing and accounting services with respect to Weis in a thorough, proper, skillful and diligent manner, and performed said services in a negligent, reckless, careless, unskilled and grossly negligent manner" (Comp. ¶28). Significantly, the common allegations contain no allegation whatsoever of *scienter* — that is, no allegation that Touche Ross had, in the words of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193-194 n.12 (1976), a "mental state embracing intent to deceive, manipulate or defraud". In their briefs here, plaintiffs themselves confirm that they did not intend to allege *scienter* and expressly point out, for example, that "[e]ssentially, both plaintiffs allege that Touche Ross was negligent" (Trustee Br. 10).

Finally, the "common" allegations assert that various consequences followed "[a]s a direct and proximate result of Touche Ross' failure to conduct the 1972 audit of Weis in accordance with generally acccepted auditing standards . . . [and] accounting principles, and the audit regulations of the Exchange and the SEC" (Comp. ¶31). Among

such consequences were that "the Weis Five were able to continue to make false and fictitious entries" during 1973 (Comp. ¶31a); that "Weis, its Board of Directors, the Exchange, the SEC, SIPC, and Weis' customers, creditors, lenders and shareholders were misled by Touche Ross into believing or assuming that as of May 26, 1972 Weis was in sound financial condition and in compliance with applicable financial responsibility rules" (Comp. ¶31c); that "Weis, its Board of Directors, the Exchange, the SEC and SIPC were prevented from . . . taking and causing to be taken appropriate and immediate remedial action at a time when a forced liquidation of Weis . . . could have been prevented" (Comp. ¶31d(iii)); and that "the assets of Weis were wasted and mismanaged" (Comp. ¶31h).

5. THE TRUSTEE'S CLAIMS. — On the basis of the "common allegations", the Trustee asserts six "causes of action" (Comp. ¶¶32-49), each of which seeks alleged damages of at least $51,000,000.

The Trustee's only federal claim is his first "cause of action" (Comp. ¶¶32-35), and concededly is his "one claim for relief . . . over which the District Court had federal question jurisdiction" (Trustee Br. 11). It charges that, by reason of the "errors and omissions" alleged in the "common" allegations, Touche Ross "violated, and aided and abetted the Weis Five in violating, Section 17 . . . and the rules and regulations promulgated thereunder" (Comp. ¶33).

The Trustee's second through sixth "causes of action" are his state-created, common law claims which he concedes arise "under the laws of New York" and "from the same facts as [plaintiffs'] Section 17 claims" (Trustee Br. 11). The Trustee's second "cause of action" (Comp. ¶¶36-37) alleges that Touche Ross' violation of Section 17 constituted negligence per se; his third (Comp. ¶¶38-39) alleges that the acts and omissions of Touche Ross constituted negligence and malpractice; his fourth (Comp.

¶¶40-42) alleges that those acts and omissions constituted gross negligence; his fifth (Comp. ¶¶43-45) alleges breach of contract; and his sixth (Comp. ¶¶46-49) alleges breach of warranty.

6. SIPC's CLAIMS. — On the basis of the "common" allegations, SIPC asserts eight "causes of action" (Comp. ¶¶50-85), the first four of which are its federal claims and the other four its non-federal, common law claims. Each of the "causes of action" seeks damages of at least $14,000,000 resulting from alleged depletion of the so-called "SIPC fund", a fund from which SIPC allegedly provided to the Trustee "funds for the payment of claims submitted by customers and certain other creditors of Weis and for certain administrative expenses of the liquidation" (Comp. ¶15). Four of SIPC's "causes of action" are asserted "in its own right" and four "as subrogee of the customers of Weis whose claims were satisfied through the depletion of the SIPC fund" (SIPC Br. 12).

SIPC's first four "causes of action" are its federal claims allegedly arising under Section 17 (SIPC Br. 12-13). The first and third "causes of action" (Comp. ¶¶50-53, 59-63) are SIPC's claims on its own behalf, the first charging that Touche Ross violated Section 17 and the third that it aided and abetted the Weis Five's violation thereof. The second and fourth "causes of action" (Comp. ¶¶54-58, 64-69) are SIPC's subrogation claims, the second alleging that Touche Ross violated Section 17 and the fourth that it aided and abetted.

SIPC's fifth through eighth "causes of action" are its claims alleging "Touche Ross' common law liability" (SIPC Br. 12, 13). The fifth and sixth "causes of action" (Comp. ¶¶70-72, 73-77) each allege that Touche Ross' acts and omissions constituted negligence and malpractice. The fifth is SIPC's claim on its own behalf, and the sixth is a subrogation claim. The seventh and eighth "causes of action" (Comp. ¶¶78-80, 81-85) each allege gross negligence. Again, the seventh is SIPC's claim on its own behalf, and the eighth is a subrogation claim.

D. The Complaint In The State Court Action.

As already noted, the complaint in the earlier-commenced State Court Action, which involves exactly the same parties as this action, asserts identical factual allegations and (except for the purported federal claims based on Section 17) identical claims, and seeks identical relief, as does the complaint here. Thus, the complaint in the State Court Action also asserts so-called "common" allegations which, except for two paragraphs set forth in the complaint here to buttress the Section 17 claims (Comp. ¶¶21-22), repeat virtually verbatim the "common" allegations here (*compare* State Comp. ¶¶4-24 *with* Comp. ¶¶8-20, 23-31[5]). Moreover, plaintiffs' "causes of action" in the State Court Action are identical to their common law "causes of actions" here (394a-395a).

E. The Status Of The State Court Action.

Plaintiffs suggest that the State Court Action has been inactive since its inception, and even represent that the State Court Action is "a parallel and virtually dormant action" in which "[n]o disclosure has been obtained by any of the parties" (SIPC Br. 6 n.). That suggestion, and those representations, are simply not so. The State Court Action has not been "dormant" and Touche Ross has begun to obtain discovery therein.[6]

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[5] The term "State Comp." refers to the complaint in the State Court Action, which is reproduced at 139a-166a.

[6] Two recent orders in the State Court Action direct plaintiffs to answer interrogatories served by Touche Ross. One order of the Supreme Court, dated July 27 and filed August 1, 1977, held that plaintiffs have waived any objections to the interrogatories and directed them to answer within 30 days. The other order was entered by a Justice of the Appellate Division on August 23, 1977, and stayed the July 27 order "conditional on the plaintiffs-appellants answering the interrogatories in good faith in their own way . . . on or before Sept. 15th". Plaintiffs have now served answers to a number of the interrogatories. This Court may, and Touche Ross requests it to, take judicial notice of the foregoing matters, which are not in dispute. See Rule 201(d), F.R. Evid.; *Massachusetts* v. *Westcott*, ___ U.S. ___, 45 U.S.L.W. 4503 n.2 (1977); *Landy* v. *Federal Deposit Ins. Corp.*, 486 F.2d 139, 150-151 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); 10 MOORE'S FEDERAL PRACTICE §201.60.

F. Other Pertinent Matters.

1. THE SEC ACTION. — In the "SEC . . . action in [the District] Court (73 Civ. 2332) against Weis and the Weis Five for injunctive relief" (Comp. ¶14), an action which led to the Trustee's appointment, the SEC complaint (132a-133a, 167a-184a) alleged violations of the securities acts in connection with Weis' allegedly false financial statements only against Weis itself and certain of its officers. Even after the "separate investigations by the Exchange and the SEC" alleged by plaintiffs here (Comp. ¶13), the SEC complaint did not allege that Touche Ross had committed or participated in or aided and abetted any such violations. A necessary conclusion is that the "investigations" by the SEC and the Exchange did not reveal that Touche Ross had committed or been involved in any violations.

2. THE INDICTMENT AGAINST THE WEIS OFFICERS AND THE GUILTY PLEAS. — Moreover, in the indictment filed in the District Court against several former Weis officers in *United States* v. *Arthur Levine, et al.* (73 Crim. 693) (133a, 185a-203a), Count I alleged that they "did fraudulently conceal from Weis' auditors, Touche Ross & Co., the existence and nature of the aforesaid fraudulent books and records and, in addition, . . . did create directly and indirectly wholly fictitious documentation for the aforesaid fraudulent entries" (189a). Three of the officers, including the former Chairman of the Board and Chief Executive Officer, the President and the Comptroller, have admitted the truth of these allegations by pleading guilty to Count I of the indictment (133a, 205a).

3. THE "CUSTOMER" ACTIONS AGAINST TOUCHE ROSS. — Since SIPC asserts "causes of action" here as the alleged subrogee of certain "customers of Weis" (SIPC Br. 12, 13; see also pp. 59-62, *in fra*), it is significant that a class action on behalf of Weis' customers was commenced against Touche Ross in the District Court as a result of the

Weis collapse (133a-134a, 208a-224a). That action was dismissed on the ground that the claims there asserted against Touche Ross — claims which were the same as those of plaintiffs here (indeed, claims which SIPC purports to assert here as an alleged subrogee) — did not state a claim for relief under the 1934 Act, but were at most non-federal, common law claims for negligence and malpractice which should be determined by the State courts. *Rich* v. *Touche Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976). The *Rich* plaintiffs have, as have other customers, commenced a State court action (134a). That action is also brought as a class action.

G. The Motion To Dismiss And Judge Wyatt's Decision.

Touche Ross moved to dismiss this action on the grounds that (i) plaintiffs' federal "causes of action" based on Section 17 of the 1934 Act fail to state a claim upon which relief can be granted, (ii) there is no subject matter jurisdiction over plaintiffs' common law "causes of action", and (iii) certain of plaintiffs' common law "causes of action" fail to state a claim upon which relief can be granted. Alternatively, the motion sought, to the extent that this action was not dismissed, a stay thereof pending determination of the State Court Action.

Judge Wyatt granted the motion to dismiss on the first two grounds, *viz.*, that plaintiffs' Section 17 "causes of action" do not state a claim for relief, and there is no subject matter jurisdiction over their common law "causes of action". That Judge Wyatt correctly decided the motion is demonstrated, with respect to the Section 17 claims, at pp. 14-67, *infra*, and with respect to the lack of subject matter jurisdiction, at pp. 68-100, *infra*.

Judge Wyatt did not reach the question of whether plaintiffs' common law "causes of action" stated any claim for relief. Likewise, he did not reach the question of whether this action should be stayed pending determination of the State Court Action, a question which this Court

also need not reach except to the extent it finds any of plaintiffs' claims to be viable (see pp. 101-103, *infra*).

ARGUMENT

I

The District Court Correctly Held That Plaintiffs' Section 17 "Causes of Action" Fail To State A Claim For Relief, Because Section 17 Does Not Create Any Implied Private Right Of Action For Damages

Section 17(a) of the 1934 Act — concededly the sole basis for the Trustee's first, and SIPC's first four, "causes of action" — is one of several sections thereof requiring reports to be filed with the SEC. Section 18(a) provides the only express remedy for misleading statements in those reports, but plaintiffs concededly are not within the class to which Section 18(a) applies (in that they were not purchasers or sellers of securities in reliance upon the allegedly misleading statements) and do not even purport to sue thereunder. Instead, they contend that Section 17(a) itself creates an implied private right of action for damages for misleading statements in reports filed pursuant thereto and that they may assert such an implied right of action. Judge Wyatt rejected that contention, held that Section 17(a) does not create any implied right of action, and dismissed plaintiffs' Section 17 "causes of action" for failure to state a claim for relief.

As shown in this Point I, Judge Wyatt correctly dismissed the Section 17 "causes of action", because Section 18(a) provides the exclusive remedy for misleading reports filed under Section 17(a), and because Section 17(a) does not create in favor of anyone, let alone in favor of plaintiffs here, an implied private right of action for damages for such reports. Moreover, as shown

in Point II of this brief, and even assuming *arguendo* that there could be an implied private right of action for damages under Section 17(a) in favor of some class, as plaintiffs would have it, Judge Wyatt's dismissal was still correct because (i) plaintiffs are not within the class intended to be protected by the 1934 Act and Section 17(a), (ii) Section 17(a) imposes no duty upon accountants such as Touche Ross, and (iii) there is no allegation of *scienter* on the part of Touche Ross.

A. The Pertinent Statutes And Rules: The Reporting Requirements Of Section 17(a) And Rule 17a-5, The Other Reporting Sections, And The Express Remedy Provided In Section 18(a) For Misleading Reports.

As the Supreme Court has recently taken pains to emphasize in cases arising under the 1934 Act, "[t]he starting point in every case involving construction of a statute is the language itself". *Santa Fe Industries, Inc.* v. *Green*, ___ U.S. ___, 45 U.S.L.W. 4317, 4320 (1977); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 24 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). Judge Wyatt here correctly recognized that the pertinent statutory language is found in the reporting provisions of Section 17(a), in the other reporting provisions of the 1934 Act, and in Section 18(a).

1. SECTION 17(a) AND RULE 17a-5. — Section 17(a), as in effect during 1972 when Touche Ross is alleged to have "certified" the Weis financial statements, required broker-dealers such as Weis to "make such reports as the [SEC] by its rules and regulations may prescribe". 15

U.S.C. § 78q(a).[7] At that time, SEC Rule 17a-5 implemented Section 17(a). 17 C.F.R. §240.17a-5 (1972). Rule 17a-5(a)(2) required that broker-dealers "file reports of financial condition containing the information required by Form X-17A-5 . . . within each calendar year". Rule 17a-5(c)(1) also provided that a broker-dealer "may file in lieu of the report required by [paragraph (a)] a copy of any financial statement which he is, or has been, required to file with any national securities exchange of which he is a member".[8]

2. THE OTHER REPORTING PROVISIONS. — Section 17(a) is only one of the sections of the 1934 Act which require the filing of "reports" or similar material. Other such provisions are found in Sections 13(a), 13(d), 13(f) and 15(d).[9] 15 U.S.C. §§78m(a), 78m(d), 78m(f),

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[7] Section 17 as in effect in 1972 is set forth at 284a. Section 17(a) then provided as follows:

> "(a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section [15] of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors". 15 U.S.C. § 78q(a).

Section 17 has been substantially amended since 1972.

[8] Rule 17a-5 has also been amended since 1972. The 1972 version thereof is set forth at 285a-288a.

[9] Section 13(a) requires every "issuer" of a registered security to file "such information and documents" and "such annual . . . and . . . quarterly reports" as the SEC may prescribe. 15 U.S.C. § 78m(a). Section 13(d) requires any person becoming the beneficial owner of more than 5% of certain classes of equity securities to file "a statement containing such . . . information" as the SEC may prescribe. 15 U.S.C. § 78m(d). Section 13(f) requires every "institutional investment manager" to file "reports" as the SEC may prescribe. 15 U.S.C. § 78m(f). Section 15(d) requires certain issuers to file "supplementary and periodic information, documents and reports" as may be required by Section 13. 15 U.S.C. § 78o(d).

78o(d). The reporting requirements of Section 17(a) and of the other sections of the 1934 Act and the rules implementing those sections are interrelated. This is seen, for example, from the express provision of Rule 17a-5(c)(2), as in effect in 1972, that in certain situations the SEC "will accept any statement of . . . financial condition filed pursuant to Sections 13 or 15(d) of the [1934 Act] . . . and the rules and regulations promulgated thereunder as a filing pursuant to [Rule 17a-5]". Compare present Rule 17a-5(k), 17 C.F.R. §240.17a-5(k) (1977).

3. SECTION 18(a). — Section 18 of the 1934 Act is entitled "Liability for Misleading Statements". 15 U.S.C. §78r. Section 18(a) provides the express remedy for misstatements in reports filed pursuant to the reporting provisions and permits a purchaser or seller of securities who relied on such statements to recover damages as follows:

> "(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to [the 1934 Act] or any rule or regulation thereunder . . . , which statement was . . . false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have *purchased or sold a security* at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading" (emphasis added). 15 U.S.C. §78r(a).

In providing a remedy for misstatements "in any . . . report, or document filed pursuant to [the 1934 Act] or any rule or regulation thereunder", Section 18(a) neces-

sarily covers reports filed pursuant to any of the reporting provisions, including Section 17(a) and Rule 17a-5. It is impossible to read Section 18(a) as not applying to Section 17(a), in light of the inescapable fact that both sections use the very same word "report" — Section 17(a) in providing that brokers and dealers shall "make . . . reports" and Section 18(a) in providing liability for misstatements in "any . . . report". The decisions expressly recognize this.[10] The legislative history of the 1934 Act also demonstrates an understanding that the Section 18(a) remedy was to be applicable to misstatements in Section 17(a) reports.[11]

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[10] See, *e.g.*, *In re Penn Central Securities Litigation*, 347 F. Supp. 1327, 1340 (E.D. Pa. 1972) ("Section 18(a) is the 'catch-all' civil liability provision for all of the reporting requirements of the [1934] Act [including § 17(a)]"), *decision as to Section 13(a) adhered to on reargument*, 357 F.Supp. 869 (E.D.Pa. 1973), *aff'd*, 494 F.2d 528, 539-540 (3d Cir. 1974) (Section 18(a) applies to "a false statement in a document filed under any other section"); *Myers* v. *American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213, 214 (S.D.N.Y. 1975), *aff'd by oral opinion*, 538 F.2d 312 (2d Cir. 1976) (Section 18 applies to "a false or misleading statement in a document filed pursuant to the [1934 Act]"); *Meer* v. *United Brands Co.*, CCH Fed. Sec. L. Rep. ¶95,648 at p. 90,213 (S.D.N.Y. 1976) ("Section 18(a) is the 'catch-all' civil liability provision for all of the reporting requirements"); *duPont* v. *Wyly*, 61 F.R.D. 615, 628 (D. Del. 1973) (citing Section 17(a) as "one of a number of provisions that require the filing of . . . reports" and holding that "[c]ivil liability for failure to comply with [all] these sections is provided in Section 18(a)").

[11] For example, Senator Fletcher, Chairman of the Senate Committee on Banking and Currency, in introducing the original bill (S. 2693) which led to the passage of the 1934 Act, submitted a digest which stated that "Section 17 [of the bill, which became Section 18 of the 1934 Act] imposes civil liability for false or misleading statements in any of the reports or records required under this act". 78 Cong. Rec. 2271 (1934). Moreover, Richard Whitney, President of the New York Stock Exchange, submitted to the Senate and House committees considering the bill a statement expressing the awareness that Section 18 would impose liability upon "persons transacting business in securities" (*i.e.*, upon broker-dealers required to file reports under Section 17(a)) for misstatements in such reports, as follows:

> "Section 17 of the bill [Section 18 of the 1934 Act] deals with the liability of any person who shall make or be responsible for making any statement in any report or document filed with the . . . Commission, which was 'in the light of circumstances under which it was made, false or misleading in respect of any matter sufficiently important to influence the judgment of an average

B. Plaintiffs Cannot State A Claim For Relief Under Section 18(a) And Therefore Are Forced To Assert That Section 17(a) Provides An Implied Private Right Of Action For Damages.

Plaintiffs cannot (and do not purport to) state any claim for relief under Section 18(a), because they do not meet its purchaser-seller requirement. Not only have plaintiffs never alleged or otherwise contended (and could not do so) that they or Weis or SIPC's purported subrogors "purchased or sold a security" as required, but SIPC expressly concedes here that "neither SIPC nor Weis' customers (SIPC's subrogors) purchased or sold any Weis stock" and therefore "SIPC and Weis' customers can not . . . meet the purchaser-seller requirement of Section 18" (SIPC Br. 35). Judge Wyatt expressly found that plaintiffs "did not purchase nor sell any security 'at a price affected by . . . ' etc., and thus cannot state a claim under Section 18" (401a).

Since plaintiffs are unable to state a Section 18(a) claim, their need to find another purported basis in the 1934 Act to "federalize" their essentially common law claims has forced them to assert that there is another damage remedy available to them for Touche Ross' alleged failure to comply with the reporting requirements of Section 17(a) — a remedy they would imply from the

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investor'. . . . In view of the unlimited character of the information which the . . . Commission has the right to require exchanges and *persons transacting business in securities,* as well as all corporations listed on a national exchange, to file with it, it will be humanly impossible to determine what facts may, in retrospect, be deemed to be sufficiently important to influence the judgment of an average investor" (emphasis added). See Hearings before the Subcommittee on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73rd Cong., 2d Sess., 6638 (1934); see also Hearings on H.R. 7852 and H.R. 8720, before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess., 226 (1934).

provisions of Section 17(a) itself. Plaintiffs' argument is that, although Section 17(a) does not expressly provide any remedy for misstatements in reports filed pursuant thereto, it creates an implied private right of action for damages for such misstatements. Plaintiffs' position is erroneous, for (as Judge Wyatt correctly held and as demonstrated hereinafter) there is clearly no such private right of action.

C. In Light Of The Statutory Scheme Of The 1934 Act, And The Express Remedy Provided By Section 18(a), Section 17(a) Does Not Create Any Implied Private Right Of Action For Damages.

In considering whether Section 17(a) creates an implied right of action for damages, it is of overriding significance that Section 18(a) already provides an express private remedy for violations of Section 17(a). Thus, unlike such cases as *Piper* v. *Chris-Craft Industries, Inc., supra, J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), and *Abrahamson* v. *Fleschner*, ___ F.2d ___, CCH Fed. Sec. L. Rep. ¶95,889 (2d Cir. 1977), *rehearing granted* (April 15, 1977), this appeal does not present a situation where a remedy is sought to be implied for violation of a statute as to which no express private remedy whatsoever is provided.[12] Rather, the situation here involves a statutory scheme in which Congress has already expressly provided both its desired statutory requirement (Section 17(a)) and the remedy (Section 18(a)) it thought necessary and appropriate for violations of that requirement, so that implying an additional remedy for such violations which Congress itself did not see fit to provide would seriously distort the statutory scheme.

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[12] See, *e.g.*, *Piper* v. *Chris-Craft Industries, Inc., supra*, 430 U.S. at 24-25 ("Section 14(e) . . . makes no provision whatever for a private cause of action, such as those explicitly provided in other sections of the 1933 and 1934 Acts. *E.g.*, §§ . . . 18 . . . of the 1934 Act").

The following analysis of the statutory context of Sections 17(a) and 18(a), the pertinent legislative history and the relevant authorities, demonstrates that Section 17(a) cannot properly be read as creating any implied private right of action for damages, and that Judge Wyatt correctly so held.

1. THE STATUTORY SCHEME WHEREBY SECTION 18(a) PROVIDES AN EXPRESS AND LIMITED REMEDY FOR MISSTATEMENTS IN SECTION 17(a) REPORTS REFLECTS A CONGRESSIONAL INTENTION THAT SUCH REMEDY BE EXCLUSIVE AND THAT NO ADDITIONAL REMEDY BE IMPLIED FROM SECTION 17(a) ITSELF. — The fact that Section 18(a) provides an express, and specifically limited, private remedy for misleading statements in Section 17(a) reports necessarily reflects a Congressional intention that the remedy would be available only under the circumstances provided in Section 18(a) — *i.e.*, where a person purchased or sold securities in reliance upon the misleading statements at a price affected by such statements — and that no other remedy for such misleading statements was intended or could be implied. Judge Wyatt recognized this, and emphasized that the express remedy of Section 18(a) "strongly suggest[s] a legislative intent that the *only* private claim for a violation of Section 17 was the claim created in Section 18" (401a).

Judge Wyatt's understanding that Congress intended Section 18(a) to be the exclusive remedy for violations of Section 17(a) is consistent with — indeed, is compelled by — recent Supreme Court decisions upon which plaintiffs themselves rely. For example, in *National Railroad Passenger Corp.* v. *National Ass'n of Railroad Passengers* ("*Amtrak*"), 414 U.S. 453 (1974), the Supreme Court held that no private right of action can be implied under the Amtrak Act in favor of railroad passengers because Section 307(a) thereof granted an express remedy only to a limited class of persons (*viz.*, the Attorney General and

certain railroad employees) that did not include such passengers, and because the implication of a private right in favor of other persons would therefore be inconsistent with the statutory scheme. The Supreme Court, noting the compelling force of the doctrine *expressio unius est exclusio alterius,* pointed out that

> "A frequently stated principle of statutory construction is that when legislation expressly provides a particular remedy or remedies, courts should not expand the coverage of the statute to subsume other remedies. 'When a statute limits a thing to be done in a particular mode, it includes the negative of any other mode.'. . . This principle of statutory construction reflects an ancient maxim—*expressio unius est exclusio alterius.* Since the Act creates . . . a private cause of action only under very limited circumstances, this maxim would clearly compel the conclusion that the remedies created in §307(a) are the exclusive means to enforce the duties and obligations imposed by the Act". 414 U.S. at 458.

Similarly, in *Securities Investor Protection Corporation* v. *Barbour,* 421 U.S. 412, 419 (1975), the Supreme Court, in holding that the express statutory grant to the SEC of a right to seek injunctive relief to enforce duties under SIPA precluded any implied private right in others to seek similar relief, reiterated the "observation [in *Amtrak*] that express statutory provisions for one form of proceeding ordinarily implies that no other means of enforcement was intended by the legislature". *Cf. Abrahamson* v. *Fleschner, supra,* CCH Fed. Sec. L. Rep. ¶95,889 at p. 91,275 ("Had Congress provided explicitly for private damage actions it would be unnecessary to consider whether the remedy should be judicially implied").

The *expressio unius* doctrine which the Supreme Court found compelling in *Amtrak* and *Barbour* is equally compelling here to require a holding that Section 17(a)

creates no private right of action. To paraphrase the Supreme Court's language in *Amtrak*, "[s]ince the [1934 Act] creates . . . a private right of action only under very limited circumstances [*i.e.*, the circumstances set forth in Section 18(a)], this maxim [*expressio unius est exclusio alterius*] would clearly compel the conclusion that the remedies created in [Section 18(a)] are the exclusive means to enforce the [reporting] duties and obligations imposed by [Section 17(a) and the other reporting provisions]". See 414 U.S. at 458.[13]

It is also significant that, as Judge Wyatt put it, "[p]laintiffs here are obliged to argue that there is an implied private claim under Section 17 [not limited by the purchaser-seller requirement and therefore] *broader* than the claim *expressly* created by Section 18 . . . because they did not purchase nor sell any security . . . and thus cannot state a claim under Section 18" (401a). However, as Judge Wyatt also expressly recognized (401a-402a), the Supreme Court itself, in *Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, recently emphasized the impropriety of implying a broader remedy for violations of the 1934 Act than the statutory remedies provided. Thus, in upholding the *Birnbaum* rule that only a purchaser or seller of a security may assert a claim under Section 10(b) and Rule 10b-5, the Supreme Court noted that the "principal express nonderivative private civil remedies, created by Congress contemporaneously with the passage of §10(b), for violations of the 1933 and 1934 Acts [including specifically Section 18(a) of the 1934 Act] are by their terms expressly limited to purchasers or sellers of secu-

[13] The Supreme Court in *Amtrak* did acknowledge that the *expressio unius* doctrine would have to "yield to clear contrary evidence of legislative intent", but then went on to examine the legislative history and to conclude that there was "no [such] contrary indication in any of the hearings or committee reports". 414 U.S. at 458, 461. As shown hereinafter (pp. 29-30, *infra*), the legislative history of the 1934 Act does not contain the "clear contrary evidence of legislative intent" necessary to overcome the application of the *expressio unius* doctrine required by the existence of Section 18(a).

rities", and emphasized that "[i]t would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action". 421 U.S. at 735-736. What the Supreme Court found to be "anomalous", of course, was any imputed Congressional intent to permit a more broadly applicable remedy (*i.e.*, a remedy not limited by the purchaser-selier requirement) for the "judicially implied cause of action" for violation of Section 10(b) and Rule 10b-5 than the remedy (*i.e.*, a remedy limited by the purchaser-seller requirement) actually specified in "comparable express causes of action" provided for violations of other provisions of the "1933 and 1934 Acts". Here, it would be even more "anomalous to impute to Congress an intention" that there be a "judicially implied cause of action" for violations of Section 17(a) which would be, as plaintiffs would have it here, far more expansive than (*i.e.*, would not be subject to the purchaser-seller requirement of) the "express [cause] of action" already provided in Section 18(a) for violations of that very Section 17(a).

Of course, as the Supreme Court also noted in *Blue Chip Stamps*, "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly". 421 U.S. at 734. Or, as Judge Wyatt paraphrased the point, "when Congress wanted to create private causes of action for violations of provisions of the 1934 Act, it knew how to do it and did do it"(403a). Consequently, Congress' failure to provide an express remedy for Section 17(a) violations for those who are not purchasers or sellers is significant to show that Congress intended and understood that there be no such remedy, either express or implied.

2. The Pertinent Decisions Hold That The Existence Of The Express And Limited Remedy Provided By Section 18(a) Precludes The Implication Of Any

PRIVATE DAMAGE REMEDY FROM THE REPORTING PROVISIONS SUCH AS SECTION 17(a). — Judge Wyatt's decision is the first square holding as to whether there is an implied right of action for damages under Section 17(a) itself. Indeed, as Judge Wyatt himself noted, "[i]n the 43 years during which the statute has been on the books, there has been no [prior] decision whether a private [implied] right of action can be asserted for a violation of Section 17" (400a-401a).[14]

However, the absence of decisions dealing directly with Section 17(a) itself does not mean that there are not decisions directly in point here. A substantial number of recent decisions (including one by the Court of Appeals for the Third Circuit) involving other reporting provisions of the 1934 Act have held — for reasons which, as Judge Wyatt recognized (402a-403a), are equally applicable to the reporting provisions of Section 17(a) — that Section 18(a) is the exclusive remedy for reporting violations and that to create an additional implied remedy for damages from the reporting provisions themselves would be to ignore the Congressional intent and distort the statutory scheme. Those decisions (even the ones that pre-date *Amtrak* and *Blue Chip Stamps*) reflect, in light of Section 18(a)'s express remedy, a clear understanding of the compelling weight of the *expressio unius* principle relied upon in *Amtrak* and of the impropriety, as emphasized in *Blue Chip Stamps*, of implying a remedy broader than the express remedy.

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[14] It does appear that, in *Rich* v. *Touche Ross & Co.*, *supra*, Judge Brieant recognized that Section 18(a) provides the sole remedy for violations of Section 17 and Rule 17a-5. The second amended complaint in *Rich* alleged that Touche Ross had improperly certified the same Weis financial statements as are involved here and was therefore liable to customers for violating, *inter alia*, Section 18 and Rule 17a-5 (217a[¶34], 220a[¶47]). Judge Brieant dismissed the complaint because it is "Section 18 [which] applies to documents filed with the SEC pursuant to its rules [including Rule 17a-5]" and because plaintiffs (who neither purchased nor sold securities in reliance upon the alleged misstatements and at a price affected thereby) did not meet the requirements of Section 18 and therefore could not state any claim upon which relief could be granted for the alleged violations of Rule 17a-5. 415 F.Supp. at 102.

One of those decisions cited by Judge Wyatt (402a-403a) is *In re Penn Central Securities Litigation,* 347 F.Supp. 1327 (E.D. Pa. 1972), *decision as to Section 13(a) adhered to on reargument,* 357 F.Supp. 869 (E.D. Pa. 1973), *aff'd,* 494 F.2d 528 (3d Cir. 1974), in which plaintiffs in actions arising out of the operations of the Penn Central companies alleged that reports filed under Section 13(a) were misleading and asserted (because they were not purchasers or sellers and thus did not fall within Section 18(a)) that they had an implied right of action for damages under Section 13(a) itself. In dismissing the Section 13(a) claims, the Court emphasized that

> "Section 13 is one of a number of provisions [of the 1934 Act] that require the filing of . . . reports. See §§ . . . 17(a). Section 18(a) is the 'catch-all' civil liability provision for all of the reporting requirements of the [1934] Act", 347 F.Supp. at 1340,

and then, although recognizing that "Courts have implied civil remedies for violations of [certain] provisions of the [1934 Act]", held that Section 18(a) "is the exclusive remedy for violation of §13(a)" because

> "when the legislature has specifically authorized or withheld the right to recover damages arising by reason of a violation of a statute, an implied right of action does not exist. . . . Where Congress has specifically authorized a remedy for violation of an act, the courts should not nullify the congressional scheme by implying a right of action on behalf of those not otherwise entitled to recover. . . . Given the express civil remedy for §13(a) provided by §18(a), we conclude that §13(a) does not afford a private right of action", 347 F.Supp. at 1339-1340.

The Court of Appeals for the Third Circuit, in affirming, emphasized that a contrary holding "would result in the

elimination of the purchaser-seller requirement for violations of § 13(a)", that no language or history in the 1934 Act "indicates that Congress intended to extend the protection offered by § 13(a) beyond the class of purchasers or sellers", and that "the same considerations [which require application of the purchaser-seller requirement to section 10(b)] also apply to [require denial of] the contention . . . that we should imply a private right of action in section 13(a) to avoid the purchaser-seller requirement of section 18." 494 F.2d at 540-541.

Other recent cases, several in this Circuit, also reject the concept of an implied private right of action for damages under the reporting sections of the 1934 Act. For example, *Meer* v. *United Brands Co.*, CCH Fed. Sec. L. Rep. ¶95,648 (S.D.N.Y. 1976), also cited by Judge Wyatt (402a), involved derivative claims on behalf of United Brands Company—claims asserted under Section 13(a) because it was not a purchaser or seller within the terms of Section 18(a)—that the individual defendants had failed to cause United Brands fully to disclose alleged bribes to foreign officials in reports filed under Section 13(a). Judge Carter dismissed, holding that in light of Section 18(a), "purchasers or sellers are the persons whom the filing requirements of Section 13(a) were designed to protect and they are the only persons to whom the statutory scheme provides a remedy for violation of the reporting provisions". *Id.* at p. 90,213.

Similarly, in another case cited by Judge Wyatt (402a), *Myers* v. *American Leisure Time Enterprises, Inc.*, 402 F.Supp. 213 (S.D.N.Y. 1975), *aff'd by oral opinion*, 538 F.2d 312 (2d Cir. 1976), Judge Weinfeld rejected an effort by plaintiffs to assert an implied private right of action for damages under the "reporting provisions" of Section 13(d). Emphasizing that plaintiffs were not purchasers or sellers within the meaning of Section 18 and noting the relevancy of Section 13(a) cases refusing to

imply a remedy not provided for by Section 18, Judge Weinfeld held that "[a]lthough there is no authority restricting standing in suits under section 13(d) to plaintiffs who are purchasers or sellers, such a holding would seem to follow logically as an extension of the Supreme Court's holding in *Manor Drug Stores*. . . . To allow suits by mere holders of securities in such cases would be to allow the plaintiffs to circumvent the Birnbaum doctrine in many cases simply by casting their complaint to include alleged violations of section 13(d)." 402 F. Supp. at 215.[15]

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[15] See also, *e.g.*, *DeWitt* v. *American Stock Transfer Co.*, CCH Fed. Sec. L. Rep. ¶96,089 at pp. 91,927-91,928 (S.D.N.Y. 1977) (dismissed count asserting "an implied, private damage action for failure to file the periodic reports required by [Sections 13(a) and 15(d)]" because plaintiff did not meet purchaser-seller requirement of Section 18 and because "no implied private damage remedy lies for violations of Sections 13(a) and 15(d)"); *Levy* v. *Johnson*, CCH Fed. Sec. L. Rep. ¶95,899 at p. 91,324 (S.D.N.Y. 1977) (dismissed count alleging violation of Section 13(a), because "plaintiff alleges neither a purchase nor sale of shares" and because "[t]his catch-all provision, section 18(a), is the exclusive remedy for violation of section 13(a) [and n]o additional remedy, under section 13(a) can be implied"); *In re Equity Funding Corp. of America Securities Litigation*, 416 F.Supp. 161, 190 (C.D. Cal. 1976) (dismissed claims based on Section 13(a) because Section 13(a) and the rules thereunder "are administrative devices not intended to provide private rights to investors, except as might be narrowly provided for in §18"); *McLaughlin* v. *Campbell*, 410 F.Supp. 1321, 1325 (D.Mass. 1976) (dismissed claims under Section 13(a) because "[g]iven the express civil remedy for §13(a) provided by §18(a), we conclude that §13(a) does not afford a private right of action"); *duPont* v. *Wyly*, 61 F.R.D. 615, 628 (D.Del. 1973) ("By including an express and expressly limited private remedy in Section 18, . . . Congress clearly negated the existence of a further implied remedy for violation of Section 13. . . . '[W]here Congress has specifically authorized a remedy for violation of an act, the courts should not nullify the congressional scheme by implying a right of action on behalf of those not otherwise entitled to recover'"). There are a few cases which, without analysis, would appear to hold to the contrary and permit a private right of action under one of the provisions of Section 13. In rejecting those cases as meaningful authority, the Third Circuit in *In re Penn Central Securities Litigation, supra,* cited them and described their defects as follows:

"In re Caesar's Palace Securities Litigation, 360 F.Supp. 366, 388 (S.D.N.Y. 1973) (denying motion to dismiss § 13 claims without

The reasoning and holdings of such decisions, although dealing specifically with the provisions of Sections 13(a), 13(d) and 15(d), are equally applicable to plaintiffs' Section 17(a) claims here. Section 17(a), to which plaintiffs look for an implied right of action in their favor, is a reporting provision just as those other sections are, and Section 18(a) is as applicable to misleading reports filed under Section 17(a) as it is to such reports filed under those other sections.

3. THE LEGISLATIVE HISTORY OF SECTION 17 DOES NOT SUPPORT AN IMPLIED RIGHT OF ACTION THEREUNDER. — As Judge Wyatt recognized (401a), nothing in the legislative history of the 1934 Act generally, or of Section 17 in particular, suggests in any way a Congressional intention that Section 18(a) be other than the exclusive remedy for violations of Section 17(a), or that there be a private right of action for damages under Section 17(a). Cf. *In re Penn Central Securities Litigation, supra*, 494 F.2d at 540 ("[w]e have not been cited to any language or to any history in the 1934 Act which indicates that Congress intended to extend the protection offered by §13(a) beyond the class of purchasers or sellers [referred to in Section 18(a)]").[16]

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discussion of this issue); . . . Kaminsky v. Abrams, 281 F.Supp. 501, 505 (S.D.N.Y. 1968) (accepting the possibility of private actions under § 13) (*dicta*); Kroese v. Crawford, '61-'64 CCH Fed. Sec. L. Rep. ¶91,262 (S.D.N.Y. 1963) (denial of motion to dismiss under §13(a), upholding private right of action, based on unexplicated 'history and purposes of the federal securities laws')". 494 F.2d at 540 n. 18.

[16] The Congressional reports with respect to the bills which became the 1934 Act make no mention of a private right of action under Section 17 and refer only to administrative enforcement by the SEC. See Sen. Rep. No. 792 at 21, 73rd Cong. 2d Sess. (1934); H. Rep. No. 1383 at 25, 73rd Cong. 2d Sess. (1934); Sen. Doc. No. 185 at 17, 73rd Cong. 2d Sess. (Conf. Rep.) (1934). Commissioner Landis described Section 17 (Section 16 of the bill) as a provision which "puts the accounting of members of the exchanges, dealing in over-the-counter markets and brokers who deal with members of the exchange under the control of the [SEC]", but no one involved in the Committee hearings suggested that there could be any private right of

Although the legislative history discloses no Congressional intention that there be any implied private right of action, it does reflect a Congressional understanding that the express Section 18(a) remedy was to apply to misstatements in Section 17(a) reports. The pertinent legislative materials have already been referred to (pp. 18-19 n. 11, *supra*), and demonstrate that plaintiffs err in asserting that the legislative history "is barren of any reference to liability for the false and misleading reports of broker-dealers filed pursuant to Section 17" and "contains no indication that [Section 18's] express remedies were intended to apply to Section 17" (SIPC Br. 36, 48).

Thus, there is lacking here the "clear evidence of legislative intent" which the Supreme Court in *Amtrak* held to be necessary to overcome the presumption that the express remedy in Section 18(a) is the exclusive remedy (p. 23 n. 13, *supra*).

4. THE STATUTORY SCHEME THUS DEMONSTRATES THAT THE ONLY CLASS PROVIDED A REMEDY FOR REPORTING VIOLATIONS IS THE CLASS OF PURCHASERS AND SELLERS REFERRED TO IN SECTION 18(a). — In light of the foregoing, it is clear that the statutory scheme created by the reporting provisions of the 1934 Act and Section 18(a) is designed to provide a remedy for any reporting violation only to the class referred to in Section 18(a), *i.e.*, to purchasers or sellers of securities in reliance upon, and at a price affected by, a misleading report. This is so whether the violation involves a report required by Section 17(a) or by any other reporting section. As Judge Carter

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action thereunder. Hearings before House Interstate and Foreign Commerce Committee on H. Rep. 7852 and H. Rep. 8720 ("Stock Exchange Regulations"), 73rd Cong., 2d Sess., Feb. 14, 1934, pp. 22, 225-226, 262, 536, 666, 670, 750, 804. Although criticism of Section 17 centered upon the expense of administrative enforcement by the SEC, see, *e.g.*, *id.* at 226, 536, 666, at no time was it proposed that the expense of public enforcement could be alleviated by permitting private suits under Section 17. Plaintiffs concede that the legislative history makes only "passing reference to the requirements of Section 17 or [is] limited to discussions of the costs of the examinations required thereby", and that "Congress just did not raise the question of remedies under Section 17" (SIPC Br. 48).

summed up the situation in *Meer* v. *United Brands Co.*, *supra*, "purchasers or sellers [within the provisions of Section 18(a)] are the persons whom the filing requirements . . . were designed to protect and they are the only persons to whom the statutory scheme provides a remedy for violation of the reporting provisions, including Section 13(a)". CCH Fed. Sec. L. Rep. ¶95,648 at p. 90,213.[17]

5. To Imply A Right Of Action Under Section 17(a) Would Be Contrary To The Purposes Of The Purchaser-Seller Requirement Of Section 18(a). — In *Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, the Supreme Court recognized that an important purpose of the purchaser-seller requirement in Section 18(a) is to require a direct and readily demonstrable connection between the alleged statutory violation and a plaintiff's alleged injury, and to exclude claims where that connection is speculative or incapable of being concretely demonstrated. Noting the SEC's own observation "that the effect, if any, of a deceptive practice on someone who has neither purchased nor sold securities may be more difficult to demonstrate than is the effect on a purchaser or seller", the Supreme Court emphasized the speculative and unreliable nature of the proof which would be permissible if the purchaser-seller requirement were eliminated and a non-purchaser or non-seller allowed to assert

[17] Of course, the fact that only purchasers or sellers have a damage remedy for reporting violations does not mean that other methods of enforcing compliance with the reporting requirements, and of thereby rectifying and minimizing such violations, are lacking. As Judge Wyatt emphasized, "it is [not] necessary to imply a civil remedy under Section 17 in order to enforce its provisions. There can be a criminal prosecution . . . . The SEC can secure an injunction where a violation is proved of Section 17 . . . . [C]riminal prosecutions and SEC injunctive actions seem abundantly sufficient" (404a, 406a). Moreover, persons who are not purchasers or sellers (*viz.*, plaintiffs here and, more importantly, the customers of Weis) always have their common law remedies, and are in fact pursuing such remedies, plaintiffs in their State Court Action and the customers in their own actions against Touche Ross in the State courts (see pp. 12-13, *supra*).

what might have been or what could have occurred but for the defendant's violation. 421 U.S. at 743-746.

Plaintiffs here allege essentially that, but for the misstatements in the Weis financial statements,

> "Weis' 1973 forced liquidation under [SIPA] *would not have* become necessary, and most if not all of Weis' assets and its good will as a going concern *could have been* preserved by a number of means . . . . Moreover, *if* a liquidation of Weis *had been necessary* as the result of . . . truthful reporting, such liquidation *could have occurred* at the end of Weis' 1972 fiscal year, when its assets were greater and the aggregate of its liabilities was lower than a year later" (emphasis added) (Comp. ¶11).

In other words, plaintiffs here talk of what "would not have become necessary", what "could have been" and what "could have occurred", making clear that their claims here are, just as the claims in *Blue Chip Stamps* were, based not upon actions which were in fact taken, but rather upon failures to take action and speculative allegations concerning what actions might have been taken and the consequences which might have resulted therefrom. Trial of such claims would hinge on speculative and subjective testimony and would raise precisely the problem which *Blue Chip Stamps* says must be avoided. Cf. *Abrahamson* v. *Fleschner, supra*, CCH Fed. Sec. L. Rep. ¶95,889 at pp. 91,279-91,280 ("the underlying concern in *Blue Chip,* though standing was involved, was . . . , perhaps, the sheer inability to disprove what a plaintiff says he *would have* done if he had but known the truth") (Gurfein, J. dissenting).[18]

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[18] Moreover, any injury to plaintiffs here was the result not of any alleged violation by Touche Ross of Section 17(a), but rather of waste and mismanagement of the Weis business and assets by the Weis Five — waste and mismanagement which is expressly alleged to have occurred here (*e.g.*, Comp. ¶¶31h, 31i). Injury resulting directly

6. THE NECESSITY STANDARD OF PIPER V. CHRIS-CRAFT INDUSTRIES, INC., BARS THE IMPLICATION OF A PRIVATE DAMAGE REMEDY UNDER SECTION 17(a).—In *Piper* v. *Chris-Craft Industries, Inc., supra,* the Supreme Court's most recent decision on the question of implying private rights of action under the 1934 Act (a decision which plaintiffs surprisingly do not even cite), the Supreme Court emphasized that a private damage remedy is to be implied only where it is "necessary to effectuate Congress' goals". 430 U.S. at 26.[19] *Piper* thus makes clear that it is improper to imply a private damage remedy simply on the ground that such a remedy would accord, or be consistent, with a general statutory purpose and that the proponent of such a remedy must show an actual necessity for implying the remedy. This Court itself has pointed out, in refusing to imply a private right of action under Section 6 of the 1934 Act in favor of the receiver of a defunct broker-dealer against the Exchange, that "[e]ven were we to agree with [plaintiff] that granting him a right of action against the Exchange would 'accord' with the purpose of the [1934] Act, our function here is to discern the intent of Congress, not to legislate in its place". *Lank* v. *New York Stock Exchange,* 548 F. 2d 61, 65 (2d Cir. 1977).

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from such waste and mismanagement, and only indirectly or remotely from an alleged violation of the 1934 Act, is not the injury sought to be prevented by the 1934 Act or its reporting provisions such as Section 17(a). The purchaser-seller requirement found in such provisions as Section 18(a) limits the class of persons who may bring private actions to those (unlike plaintiffs here) whose injuries (*viz.*, purchases of securities at prices inflated, or sales of securities at prices depressed, by misstatements) result directly and demonstrably from violations of the 1934 Act and not from corporate waste and mismanagement allegedly made possible by such violations. *Cf. Santa Fe Industries, Inc.* v. *Green, supra,* 45 U.S.L.W. at 4322 ("Congress . . . did not seek to regulate transactions which constitute no more than internal corporate mismanagement"); *Hoover* v. *Allen,* 241 F. Supp. 213, 225 (S.D.N.Y. 1965); *Bio-Medical Sciences, Inc.* v. *Weinstein,* 407 F. Supp. 970, 974 (S.D.N.Y. 1976).

[19] In its discussion, the Supreme Court italicized "necessity" once and "necessary" twice, thus emphasizing that "necessity" is the standard for implying private causes of action under the federal securities laws. 430 U.S. at 425.

The foregoing discussion of the statutory context of Section 17(a) and the express and limited remedy provided in Section 18(a) demonstrate that the implication of a private damage remedy under Section 17(a) would be inconsistent with the statutory scheme and the Congressional intent reflected therein. However, even if that showing be ignored, and even assuming *arguendo* that the implication of a damage remedy under Section 17(a) could be said to be in accord with the general statutory purpose of protecting investors, it would still be inappropriate to imply such a remedy in light of the necessity standard articulated in *Piper*. Plaintiffs and the SEC simply cannot demonstrate that the implication of a Section 17(a) remedy is necessary, and Judge Wyatt himself pointed out (for reasons discussed at pp. 44-47, *infra*) that the "[*Piper*] test has . . . been applied here and no such implication [was] found 'necessary'" (406a-407a).

* * *

Thus, the clear statutory language, the legislative history and the authorities require the conclusion that Section 18(a) is the exclusive remedy for misstatements in Section 17(a) reports. That such remedy would be unavailable to some persons (such as plaintiffs here) who do not meet the purchaser-seller requirement but who conceivably might be injured as a result of such misstatements simply reflects a Congressional intention that no *federal* remedy be available to such persons, and is consistent with the fact that the 1934 Act was never intended to provide a *federal* remedy for every conceivable dereliction.[20] Such persons still have their State court

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[20] See 78 Cong. Rec. 2270 (1934) (remarks of Senator Fletcher, sponsor of Senate bill S.2693 which eventually became the 1934 Act). Cf. *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963, 969 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970) ("That the conduct averred in any given case may be reprehensible does not

remedies, as plaintiffs here well understand in maintaining their State Court Action on the basis of allegations identical to those asserted here,[21] and it would impermissibly conflict with the clear statutory scheme to disregard the requirements of Section 18(a) in order to permit such persons also to sue in the federal court.

D. The Contentions Asserted By Plaintiffs And The SEC To Support An Implied Private Right Of Action For Damages Under Section 17(a) Are Without Merit And Must Be Rejected.

Plaintiffs' argument that Section 17(a) creates an implied right of action for damages in their favor is primarily set forth in SIPC's brief (pp. 16-50), and is incorporated by reference into the Trustee's brief (p. 2). The SEC's *amicus* brief restates of the argument that SIPC has such a right of action.[22] Those arguments are without merit, and must be rejected.

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mean that a federal remedy must be furnished by judges. The remedy in many cases may be found in the state courts. . . . If there is to be a federal remedy, it is the Congress which must create it"), cited with approval in *Blue Chip Stamps* v. *Manor Drug Stores, supra*, 421 U.S. at 738-739 n. 9.

[21] Cf. *Blue Chip Stamps* v. *Manor Drug Stores, supra*, 421 U.S. at 738-739 n. 9 (observing that any disadvantages of the purchaser-seller rule are "attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law", that redress for the conduct alleged in the *Birnbaum* case ultimately was obtained "in a cause of action based on state law", and that plaintiffs in *Blue Chip Stamps* had commenced a parallel state court action). See also pp. 48-49, *infra*.

[22] The SEC's views are entitled to no deference here. See *Piper* v. *Chris-Craft Industries, Inc., supra*, 430 U.S. at 41 n. 27 ("Even if the [SEC] spoke with a consistent voice, . . . its presumed 'expertise' in the securities law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution, namely whether a cause of action should implied by judicial interpretation in favor of a particular class of litigants. Indeed, in our prior cases relating to implied causes of action, the Court has understandably not invoked the 'administrative deference' rule, even when the SEC supported the result reached in the particular case"); *Blue Chip Stamps* v. *Manor Drug Stores, supra*, 431 U.S. at 759-760 and n. 4 (Powell, J., concurring).

The major error of plaintiffs and the SEC is that they talk in generalities about Section 17(a), and seek to imply a damage remedy from Section 17(a) without even considering its critical statutory context, including Section 18(a). In fact, they take the astounding position that Section 18(a) is simply "not relevant" here, and that its express remedy for misstatements in "any . . . report" does not apply to "reports" required by Section 17(a). Of course, it is easier for them to contend here for an implied private right of action by taking Section 17(a) out of context, and by simply pretending away the critical provisions of Section 18(a), but such contentions can have no weight.

1. PLAINTIFFS AND THE SEC ERR IN RELYING UPON GENERALITIES ABOUT THE PURPOSE OF SECTION 17(a) AND THE CONTENTION THAT IMPLICATION OF A PRIVATE DAMAGE ACTION WOULD BE CONSISTENT THEREWITH. — Plaintiffs and the SEC devote substantial space to generalities about the purported place of Section 17(a), and the role of accountants, in the regulatory scheme of the 1934 Act, and they conclude therefrom that Section 17(a) creates an implied private damage remedy (*e.g.*, SIPC Br. 4, 14-15, 16-32; Trustee Br. 4-6; SEC Br. 6-13). Thus, they go on at great length seeking to establish (i) a legislative concern for "investor protection", (ii) the role of the reporting requirements of Section 17(a) and Rule 17a-5 in providing protection of investors, including "customers of broker-dealers", (iii) the requirements of Rule 17a-5, and the use of the audited reports it requires by the SEC, SIPC and others, and (iv) the importance of audits by, and the duties of, independent accountants.

The discussion by plaintiffs and the SEC of such generalities in large part exaggerates the requirements and relative significance of Section 17(a) and Rule 17a-5 and

presents a distorted view.[23] However, while examples of specific problems with that discussion are hereinafter referred to where pertinent, it is unnecessary for present purposes to quarrel with the generalizations, and it can be taken as correct that the federal securities laws, including Section 17(a) and Rule 17a-5, are intended to protect public investors and that audits by independent public accountants are important in achieving that purpose.

The real difficulty with these generalizations is the patently erroneous conclusion which plaintiffs and the SEC would draw therefrom, *viz.*, that, because a broker-dealer is required to obtain an accountant's certification for the financial report made by the broker-dealer pursuant to Section 17(a) and Rule 17a-5 and because that report is useful and important in implementing the regulatory scheme of which the 1934 Act is a part, Section 17(a) necessarily supplies to plaintiffs an implied right of action for damages against the accountant for misstatements in the report. As recognized by the Supreme Court in *Piper* v. *Chris-Craft Industries, Inc., supra*, and this Court in *Lank* v. *New York Stock Exchange, supra*, determination of whether Section 17(a) creates any implied private right of action requires a far more discriminating analysis of Section 17(a) and its pertinent statutory context, including Section 18(a), than recitation of plaintiffs' generalities and their assertion that the

[23] For example, plaintiffs distort an article by Mr. Weinstein, a partner in Touche Ross (SIPC Br. 28-29). While Mr. Weinstein did point out (in passages quoted by SIPC) that accountants have "a responsibility to determine when financial statements do not present fairly the financial position of a company" and should "strive to detect" management fraud, he also emphasized (in passages which SIPC conveniently fails to quote) that "every instance of management fraud cannot be detected", that accountants "cannot be scapegoats", that the "public must mature and temper its expectations" as to what can be expected from accountants, and that "[t]he public is not served by having [the accounting] profession exposed to unlimited and unbearable liability". Weinstein, *A Time of Travail and Challenge*, 44 CPA J. 29, 30 (December 1974).

implication of such a right of action would be consistent with the statutory purposes (SIPC Br. 45).[24]

2. PLAINTIFFS AND THE SEC ERR IN ASSERTING THAT SECTION 18(a) IS NOT RELEVANT TO SECTION 17(a). — Plaintiffs seek to avoid the obviously chilling effect of Section 18(a) on their claim of an implied remedy under Section 17(a) by asserting the untenable proposition that "Section 18 is simply not relevant to . . . Section 17" (SIPC Br. 15, 33-37). Plaintiffs' argument, which Judge Wyatt understood and rejected (403a), apparently is that (i) the "1934 Act itself has a two-fold purpose — to protect the purchasers or sellers of securities . . . and to protect the customers of brokers-dealers" (SIPC Br. 19); (ii) Section 18 "is concerned with the rights of purchasers and sellers", while Section 17 "protects customers from the broker-dealers" (SIPC Br. 33, see also 15); and (iii) therefore, since the Trustee, SIPC and Weis' customers (SIPC's alleged subrogors) are not purchasers or sellers of securities, Section 18 is inapplicable to them and they are entitled to look to Section 17 for protection. While the SEC does not talk expressly in the "relevancy" terms used by plaintiffs, it does treat Section 18(a) as irrelevant by largely ignoring it, and by asserting that "various provisions of the federal securities laws are addressed to specific concerns other than the relationship between purchasers and sellers of securities" and that, despite the existence of Section 18(a), Section 17(a) should be

[24] To support their erroneous contention that a private damage remedy may be implied if it is merely consistent with a general statutory purpose, plaintiffs cite three Supreme Court decisions, *Cort* v. *Ash*, 422 U.S. 66 (1975), *Securities Investors Protection Corp.* v. *Barbour, supra, and Amtrack, supra,* each of which in fact held that no private right of action could be implied under the pertinent statutory provisions because — as here (see pp. 21-22, *supra*) — to do so would be *inconsistent* with the legislative scheme. None of those cases hold that consistency with the legislative scheme, without more (and without a showing of necessity), was sufficient to require implication of a private right of action. See also *Lank* v. *New York Stock Exchange, supra,* 548 F.2d at 65 (it is insufficient for proposed implied remedy merely to "accord" with purpose of 1934 Act).

construed "flexibly to effectuate its remedial purposes" (SEC Br. 17, 18 n. 25).

Those contentions are erroneous for various reasons. In the first place, plaintiffs' assertion that Section 18(a) is "simply not relevant" to Section 17(a) is patent nonsense in any context. As already shown (pp. 17-18, *supra*), Section 18(a) simply cannot be read as inapplicable to Section 17(a), in light of Section 17(a)'s express requirement that broker-dealers shall "make . . . reports" and Section 18(a)'s express remedy for misleading statements in "any . . . report". That inescapable fact was clearly recognized not only by Judge Wyatt, but also by the numerous decisions cited at p. 18 n. 10, *supra*, which hold that Section 18(a) applies to, and provides the exclusive remedy for violations of, all the reporting sections, including Section 17(a).[25]

Plaintiffs' argument that Section 18(a) was intended to affect only the rights of purchasers and sellers, and not the rights of customers of broker-dealers, is plainly erroneous. The language, context and history of Section 18(a) — and the fact that Section 18 is entitled "Liability for Misleading Statements" (instead of, for example, "Rights of Purchasers-Sellers") — plainly demonstrate that the Congressional intention in Section 18(a) was not simply to grant a remedy to purchasers and sellers, but to delineate the full scope of liability for misleading state-

[25] Plaintiffs' contention that Section 18(a) does not apply to Section 17(a) reports creates numerous anomalies. For example, why should the "reports" expressly referred to in Sections 13(a), 13(f) and 15(d) be included within the term "any . . . report" as used in Section 18(a), and the "reports" expressly referred to in Section 17(a) not be so included, particularly when Rule 17a-5(c)(2) expressly permits a report "filed pursuant to Sections 13 or 15(d)" to be accepted "as a filing pursuant to [Rule 17a-5]" (see p. 17, *supra*). As another example, if a Section 13(a) report were filed as compliance with Rule 17a-5, as permitted by Rule 17a-5(c)(2), would a person who is not a purchaser or seller of securities but who is damaged by a misstatement in the report be foreclosed from a private right of action under Section 13(a), see cases cited at pp. 25-28, *supra*, but nevertheless have a private right of action under Section 17(a), as plaintiffs here contend?

ments in filed reports by providing that purchasers and sellers were the only class of persons to whom a remedy for such statements was to be available. Cf. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. at 734 ("When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly"). Indeed, the consistent and predominant pattern of the 1934 Act is to limit private remedies to purchasers and sellers. *Id.* at 735-736 ("The principal express nonderivative private civil remedies . . . are by their terms expressly limited to purchasers or sellers of securities").

In fact, even if plaintiffs were correct in their contention that Section 18(a) was intended only to provide rights to purchasers and sellers while Section 17(a) was intended "to protect the customers of broker-dealers", that contention merely serves to emphasize that Congress also necessarily intended that the purchasers and sellers referred to in Section 18(a) be the only class of persons to whom a damage remedy for misleading reports was to be available. According to plaintiffs, "the legislative history of the 1934 Act in general and of Section 17 in particular . . . all demonstrate that the protection of a broker-dealer's customers, irrespective of any purchaser-seller requirement, has been a central concern of Congress" (SIPC Br. 35). In other words, according to plaintiffs, Congress was consciously concerned in enacting the 1934 Act with both protecting purchasers and sellers (and went so far as to provide them with an express damage remedy in Section 18(a)) and protecting the customers of broker-dealers (but nevertheless did not see fit to provide them with any such express remedy). Under such circumstances, and since Congress was purportedly as aware of the customers as of the purchasers and sellers, the withholding of an express damage remedy from the customers, while at the same time giving such a remedy to the purchasers and sellers, can only mean that Congress consciously intended

that the customers not have a damage remedy and that their protection be provided in a different way — for example, as Judge Wyatt recognized (404a, 406a), by criminal proceedings and SEC injunctive actions, or by relegating them to State law remedies.

3. PLAINTIFFS AND THE SEC ERR IN PURPORTING TO DISTINGUISH THE SECTION 13 DECISIONS. — Plaintiffs and the SEC purport to distinguish, without discussion or analysis, the decisions holding that Section 18(a) provides the exclusive remedy for misstatements in Section 13 reports on the ground they held "the purchaser-seller requirement of Section 18 . . . applicable [only] to Section 13" (SIPC Br. 36; SEC Br. 17 n. 24). [26] That distinction, as Judge Wyatt recognized, is much too narrow and misses the pertinent point, *viz.*, that the decisions recognize, in reaching their conclusions as to Section 13, that Section 18(a) provides the exclusive remedy for all of the reporting provisions of the 1934 Act, including Section 17(a).[27]

4. PLAINTIFFS ERR IN THEIR READING OF THE LEGISLATIVE HISTORY. — Plaintiffs distort the legislative history. For example, as already noted (pp. 18-19, n. 11, *supra*), they err in asserting that the legislative history "is barren of any reference to liability for the false and misleading reports of broker-dealers filed pursuant to Section 17" and "contains no indication that [Section 18's] express re-

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[26] At least one decision also involved the reporting provisons of Section 15(d). *Dewitt* v. *American Stock Transfer Co.*, *supra*.

[27] Plaintiffs concede that at least one of the Section 13 decisions (actually, there are more) refers specifically to Section 17, but would dismiss the reference as "purely *dictum*" (SIPC Br. 36 first n.). However, the conclusion in those decisions that Section 13 is one of a number of reporting requirements in the 1934 Act to which Section 18 applies — a number which includes Section 17(a) — would appear to be more holding than *dictum*. And even if it technically were *dictum*, it is far more reasoned and persuasive than plaintiffs' arguments here. The SEC refers to, but expressly refuses to discuss, its purported "serious doubts as to the wisdom of [the] holdings" of the Section 13 cases (SEC Br. 17 n.24). It also cites, as contrary authority, *Kroese* v. *Crawford*, an old Southern District case which the Third Circuit in *In re Penn Central Securities Litigation* explicitly and properly rejected as unacceptable authority (see pp. 28-29 n. 15, *supra*).

medies were intended to apply to Section 17" (SIPC Br. 36, 48). The legislative materials already referred to show that it was well-understood during the process of legislative enactment of the 1934 Act that the provision which became Section 18 could impose liability upon "persons transacting business in securities" (*i.e.*, upon broker-dealers) for misstatements in reports required under the provision which became Section 17.[28]

[28] Plaintiffs also distort when, in pointing out that at the time "only individuals — not corporation[s] — could be members of the Exchange" (and thus be broker-dealers), they refer to legislative testimony about the impact of Section 18 on corporations as evidence that Section 18 was not viewed "as having any impact on broker-dealers" (SIPC Br. 37). For example, they quote from the testimony before the Senate Committee on Banking and Currency of Mr. Altschul, Chairman of the Exchange's Committee on Stock List, who in the course of testifying about the difficulties which would be experienced by listed companies under the registration and reporting requirements of the proposed legislation, stated merely that it would be impossible for corporations to comply with Section 18. SIPC's conclusion that therefore "Mr. Altschul obviously did not view Section 18 as having any impact on broker-dealers" is ridiculous, because he did not so testify (*id.*). By virtue of his position, Mr. Altschul was familiar primarily with corporations listed on the Exchange, and he was testifying about the problems they would experience under the proposed legislation — and nothing more. In pointing to Mr. Altschul's testimony, plaintiffs' erroneous suggestion is that, because broker-dealers who were Exchange members at the time of enactment of the 1934 Act could not be corporations (a rule later changed), they could not be issuers of securities which could be bought or sold, and therefore misstatements in their Section 17(a) reports could not give rise to a Section 18(a) remedy. Of course, many broker-dealers now are corporations, the securities of which are traded, and purchasers or sellers of such securities clearly would be entitled to seek damages under Section 18(a). Moreover, even broker-dealers which are (or were) partnerships can and always could be issuers of "securities", the purchasers or sellers of which would have a remedy under Section 18(a). See, *e.g.*, *New York Stock Exchange* v. *Sloan*, 394 F.Supp. 1303 (S.D.N.Y. 1975) (limited partnership interests in, and subordinated loans to, broker-dealer partnership held to be "securities"). Indeed, in *Exchange Nat'l Bank* v. *Touche Ross & Co.* (S.D.N.Y. 75 Civ. 916), Judge Wyatt recently sustained a Section 18(a) claim asserted by the plaintiff bank which allegedly purchased securities of Weis (in actuality, it made subordinated loans to Weis) in reliance upon the Section 17(a) reports of Weis which are involved here.

5. PLAINTIFFS AND THE SEC ERR IN RELYING UPON J. I. CASE CO. V. BORAK.—Plaintiffs and the SEC erroneously rely on *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964) (SIPC Br. 41-45; SEC Br. 16-18, 24-26). As Judge Wyatt recognized, not only is "the case at bar . . . not like *Borak*", but the "Supreme Court [in such cases as *Cort* v. *Ash* and *Piper* v. *Chris-Craft Industries, Inc.*] has refused to expand the Borak principle" and "indeed . . . has restricted it" (404a-406a). Other decisions also have recognized that *Borak* is not authority for implying a private right of action for damages from the reporting provisions of the 1934 Act. *E.g., In re Penn Central Securities Litigation, supra,* 347 F. Supp. at 1340.

Section 14(a) of the 1934 Act—the statutory provision involved in *Borak*—is designed to protect a stockholder's voting rights, and (through Rule 14a-9) makes "unlawful" any false or misleading proxy statement. The Supreme Court in *Borak* found it "necessary" to imply a private right of action to protect Section 14(a) rights for various reasons which make *Borak* distinguishable from this case. In the first place, there was no express remedy provided in the 1934 Act for violations of Section 14(a), an aspect emphasized by *Piper* ("the relevant provisions are silent as to remedies"—430 U.S. at 25). Moreover, Section 14(a), far from simply imposing reporting requirements, "stemmed from the congressional belief that '[*f*]*air corporate sufferage is an important right* that should attach to every equity security bought on a public exchange' ". 377 U.S. at 432; see also *Piper* v. *Chris-Craft Industries, Inc., supra,* 430 U.S. at 25.

Judge Wyatt correctly recognized that *Borak* is inapplicable here, where the Section 17(a) reports in issue were not intended to provide information to investors to aid them in their decisions:

> "the case at bar is not like *Borak*. The reports required by Section 17 in 1972 were not for the

> information of any 'investors' and were not sent to them but were for the SEC, primarily for monitoring the net capital requirements of the 1934 Act" (405a).

Consequently, as Judge Wyatt emphasized, whereas the Supreme Court has "referred to *Borak* as an instance where there was 'a pervasive legislative scheme governing the relationship between the plaintiff class and the defendant class in a particular regard' ", here there is "no such 'pervasive legislative scheme' " (406a). Indeed, the "legislative scheme" of which Section 17(a) is a part includes Section 18(a) and its express remedy for the class to which Congress intended to give a remedy, and compels the conclusion (contrary to that reached in *Borak*) that Congress intended no other remedy to be available.

Plaintiffs also err in trying to bring their Section 17(a) claims within the rationale of *Borak* by unduly emphasizing the "protection of investors" language of Section 17(a) and the similar language relied upon in *Borak* (SIPC Br. 43). That a particular statutory provision is intended for the "protection of investors" does not necessarily mean that a private right of action is to be implied thereunder. See, *e.g., Securities Investor Protection Corporation* v. *Barbour, supra,* 421 U.S. at 421; *In re Equity Funding Corp. of America Securities Litigation, supra,* 416 F. Supp. at 190.[29]

Judge Wyatt also recognized that an indispensable element of the decision in *Borak* was that an implied private remedy under Section 14(a) was a "necessary

[29] See also *Amtrak, supra,* where the Supreme Court refused to imply a private right of action under the Amtrak Act in favor of an association of railroad passengers despite that fact that "railroad passengers are the intended beneficiaries of the [Amtrak] Act" and despite the citation of *Borak*. See 414 U.S. at 457. Of course, as shown hereinafter (pp. 49-63, *infra*), even if Section 17(a) were assumed to create a private right of action in favor of the protected class of "public investors", plaintiffs would not be entitled to assert that right because they are not members of that class.

supplement to [SEC] action" because the SEC "had not the time for an 'independent examination' " of proxy material (405a). See also *Piper* v. *Chris-Craft Industries, Inc.*, *supra*, 430 U.S. at 25. Here, on the other hand, Judge Wyatt understood that it is not "necessary" to imply a private right of action under Section 17(a) because

> "in examining the records and reports made under Section 17(a) the SEC does not have the time limitations applicable to the *Borak* proxy statements (ten days in some cases (17 CFR § 240.14a6(a)) and two days in others (17 CFR § 240.14a-6(b)). The SEC has an inspection program, similar to that of bank examinations. It is not 'necessary' to enforce Section 17 by private actions; criminal prosecutions and SEC injunctive actions seem abundantly sufficient. If, as is the case, the record keeping requirements of Section 17 are to give early warning to the SEC of financial difficulties of a broker and thus avoid liquidation, it cannot help to imply a private right of action after liquidation has become a fact" (405a-406a; see also 404a).

Plaintiffs erroneously characterize as a "rather unrealistic suggestion" Judge Wyatt's finding that "criminal prosecutions and SEC injunctive actions seem abundantly sufficient" to enforce Section 17(a), on the basis of their unsupported assertion that such prosecutions and injunctive actions have an insufficient deterrent effect (SIPC Br. 49-50). However, as Judge Wyatt recognized, whereas proxy violations might go undetected and unpunished absent a private remedy, a Section 17(a) violation which has serious consequences will necessarily be detected "after liquidation has become a fact". Moreover, "[t]he indictment of the Weis Five and the injunctive relief obtained by the SEC against them" (SIPC Br. 49; see 132a-133a, 167a-184a, 185a-203a, 204a-207a) demonstrate that the SEC has the ability, capacity and intention

to investigate and seek punishment and sanctions for Section 17(a) violations. Not only is there thus no merit to plaintiffs' argument that absent an implied private right of action for damages there will be no deterrence and Section 17(a) will be a "paper tiger" (SIPC Br. 59), but the converse of their argument—*viz.*, that such a private right of action for damages would provide a substantial additional deterrent effect on prospective wrongdoers—has been found unpersuasive by the Supreme Court. *Piper* v. *Chris-Craft Industries, Inc.*, *supra*, 430 U.S. at 39-40 ("Nor can we agree that an ever-present threat of damages . . . will provide significant additional protection . . . The deterrent value, if any, of such awards can never be ascertained with precision").

Plaintiffs suggest that it was improper for Judge Wyatt to have taken notice that "[t]he SEC has an inspection program, similar to that of bank examinations" (406a) on the purported ground that "the [District] Court's finding was nowhere supported by the record before it" and "[t]hat record is devoid of any basis for [so] concluding" (SIPC Br. 44). That criticism of Judge Wyatt is, of course, entirely unwarranted, since the activities of the SEC plainly constitute "legislative facts" of which a court is fully entitled to take judicial notice. See generally 1 WEINSTEIN'S EVIDENCE ¶200[03]. Plaintiffs also assert that Judge Wyatt was "simply wrong" in his assessment of the SEC's inspection program, an assertion which is based solely upon their own self-serving and perfunctory description of the SEC's activities, which omits to note important facts about that program.[30] While plaintiffs would belittle the SEC's inspection program,

[30] The SEC itself concedes that its "broker-dealer inspection program is an extensive one" and goes on to specify that it examines "[e]ach of the approximately 750 broker-dealers who are not members of self-regulatory organizations . . . every year for compliance with Commission regulations" as well as "roughly 5 percent" of those belonging to self-regulatory organizations and "about 500" each year "for 'cause' (usually as a result of a complaint received)" and that under certain circumstances "much closer scrutiny is provided by the Commission" (SEC Br. 25-26 n.37)

Congress regards it as being an important part of the regulatory scheme of which Section 17(a) is a part. See S. Rep. No. 94-75, 94th Cong., 1st Sess. 120, reprinted in [1975] U.S. Code Cong. & Adm. News 179, 297 ("Examining authority, contained in present Section 17(a) is, of course, essential to any effort by the Commission to discharge its responsibilities under the Act"). Moreover, even if it be assumed, as plaintiffs and the SEC suggest, that there are practical restraints on the SEC's ability to perform examinations, such restraints themselves are insufficient to require implication of a private right of action under Section 17(a). *Piper* v. *Chris-Craft Industries, Inc.*, *supra*, 430 U.S. at 41 ("Even though the SEC operates in this context under the same practical restraints recognized by the Court in *Borak*, institutional limitations alone do not lead to the conclusion that any party interested . . . should have a cause of action for damages").

6. PLAINTIFFS AND THE SEC ERR IN RELYING UPON CORT V. ASH — Plaintiffs and the SEC also rely upon *Cort* v. *Ash*, 422 U.S. 66 (1975), arguing that implication of a Section 17(a) remedy here would be required under the factors identified in *Cort* (SIPC Br. 45-50; SEC Br. 5-29). However, their arguments are seriously weakened by their failure to take into account certain critical matters. For example, *Cort* itself, and subsequent decisions referring to the *Cort* factors, *e.g.*, *Piper* v. *Chris-Craft Industries, Inc.*, *supra*, and *Abrahamson* v. *Fleschner*, *supra*, involved attempts to imply a remedy where there was no express private remedy whatsoever for violation of the statute in question. Consequently, it is doubtful that the *Cort* factors constitute a satisfactory model for analyzing the much different situation here, where Section 18(a) does provide an express private remedy for misstatements in Section 17(a) reports. Moreover, the Supreme Court has recognized that the *Cort* factors are not all-inclusive, and in *Piper* expressly emphasized the importance of the additional factor of necessity (*i.e.*, whether an implied remedy

is "necessary to effectuate Congress' goals") (see pp. 33-34, *supra*). Although plaintiffs concede that "the *Cort* factors must be applied in conjunction with the criteria set forth in other cases" (SIPC Br. 46; see also SEC Br. 5), their analysis neglects those "other cases", particularly *Piper* and its necessity requirement.

In any event, even if the *Cort* factors were assumed to be the appropriate ones, they here require the conclusion that Section 17(a) creates no implied private right of action. First, insofar as substantive rights may be derived from reporting obligations imposed by the 1934 Act, only persons who are purchasers or sellers may be said to belong to the "class for whose *especial* benefit the statute was enacted", see pp. 17, 21-31, *supra*, even though the statute through its administrative scheme as opposed to its scheme of civil remedies more generally seeks to provide protection for public investors (which the particular plaintiffs involved here of course are not — see pp. 52-56, *infra*). Second, the statutory scheme reflects a legislative intent to deny a remedy here. Section 18(a) provides an express cause of action for purchasers and sellers of securities who rely in their securities transactions upon misleading reports filed under Section 17(a). That fact, combined with legislative history which shows no express intention to create a remedy for anyone other than purchasers and sellers, evidences a Congressional intention to restrict causes of action to those who satisfy the requirements of Section 18(a). Third, an implied right would not be consistent with the legislative scheme since it would effectively abolish the limitations that Congress placed on express civil remedies. Finally, the cause of action which plaintiffs allege—by their own admission essentially a cause of action for negligence (Trustee Br. 10)—is one normally relegated to a common law action for accountants' malpractice. Plaintiffs have recognized this by commencing and maintaining here and in the State Court Action their common law "causes of action" based

upon the law of New York. The Supreme Court has recently restated the principle that when matters have in the past been governed by State law the federal courts should be reluctant to intrude federal remedies into the area to serve " 'at best a subsidiary purpose' of the federal legislation," *Santa Fe Industries, Inc.* v. *Green, supra,* 45 U.S.L.W. at 4321-4322, and recognized that plaintiffs may appropriately be relegated to whatever remedy is created by State law. *E.g., Santa Fe Industries, Inc.* v. *Green, supra,* 45 U.S.L.W. at 4321 (proper to relegate plaintiffs to Delaware appraisal remedy); *Piper* v. *Chris-Craft Industries, Inc., supra,* 430 U.S. at 40-41 (proper to relegate plaintiff to common law tort remedy); see also *Rich* v. *Touche Ross & Co., supra,* 415 F. Supp. at 104 (proper to relegate customers of Weis to state law malpractice action against Touche Ross).

II

The District Court Correctly Held That Plaintiffs' Section 17 "Causes Of Action" Fail To State A Claim For Relief, Even Assuming *Arguendo* That There Could Be An Implied Right Of Action For Damages Under Section 17

Even assuming *arguendo* that there could be an implied private right of action under Section 17(a) of the 1934 Act, as plaintiffs assert, Judge Wyatt was still correct in dismissing their Section 17 "causes of action" for failure to state a claim for relief. This is because (i) plaintiffs are not members of the class intended to be protected by Section 17(a), (ii) Section 17(a) imposes no duty upon accountants such as Touche Ross, and (iii) there is no allegation of *scienter* on the part of Touche Ross.

A. Plaintiffs Are Not Members Of The Class Of Public Investors Intended To Be Protected By Section 17(a).

Judge Wyatt clearly recognized that, even if it could somehow be said that Section 17(a) creates an implied

private damage remedy, plaintiffs still do not state a claim for relief thereunder because they do not fall within the class of public investors which the 1934 Act and Section 17(a) thereof were intended to protect. As Judge Wyatt held, "neither the trustee nor SIPC is an investor" and therefore "neither the trustee nor SIPC could possibly have been meant to be protected by Section 17" (407a).

In reaching his holding, Judge Wyatt relied upon the recent decisions of the Supreme Court in *Piper* v. *Chris-Craft Industries, Inc., supra,* and of this Court in *Lank* v. *New York Stock Exchange, supra.* In *Piper,* the Supreme Court held that a defeated tender offeror could not assert an implied private right of action under Section 14(e) of the 1934 Act, because any such remedy may be implied only "in favor of the particular class intended to be protected by the statute" and "tender offerors were not the intended beneficiaries of [Section 14(e)]". As the Supreme Court noted, "the sole purpose of [Section 14(e)] is the *protection of investors* who are confronted with a tender offer" and "a party [*i.e.,* the defeated tender offeror] whose previously unregulated conduct was purposefully brought under Federal control by the statute . . . can scarcely lay claim to the status of 'beneficiary' whom Congress considered in need of protection". 430 U.S. at 25, 28, 35, 37 (emphasis added). In *Lank,* this Court held that the receiver of a defunct broker-dealer had no claim for relief, on behalf of the broker-dealer, against the Exchange for alleged violations of its duties under Section 6 of the 1934 Act to enforce compliance with its rules (including the net capital rules), because the broker-dealer was not within the "class of public investors" which the 1934 Act was intended to protect. This Court explained that

> "the primary purpose of the [1934] Act was to protect customers of the stock exchanges — that is, *public investors.* One method of effectuating this was to impose [by Section 6] on the exchanges a statutory

> duty 'to *protect investors* by regulating [the exchanges'] members' . . . . In *Baird* v. *Franklin* . . . this court held that when an exchange breaches the duty prescribed by Section 6 to enforce its rules, a private right of action arises in favor of *public investors.* Judge Clark . . . characterized the implication of such a private right of action as necessary to effectuate the Congressional purpose of protecting *public investors,* the class Congress intended the statute to protect . . . . Judge Clark recognized, however, that *not every person who might be injured by an exchange's dereliction would have a cause of action.* . . . This long established rule is: that before a private right of action may be inferred *the would-be plaintiff must show that he is within the class the statute is intended to protect,* and that it is not sufficient merely to show that the defendant is within the class the statute is designed to regulate . . . . The beneficiary of the 1934 legislation was intended to be *the public investor.* . . . There is no indication whatsoever that members of the exchanges were considered to be within the *class of public investors* Section 6 of the Act was designed to protect",

and then concluded that "a securities exchange is not liable to a member organization for failure to force the member to comply with the exchange's rules" and "if the member has no cause of action, its receiver also has none" (emphasis added). 548 F.2d at 64-66.

Although Weis (on behalf of which the Trustee sues) and SIPC concededly are not public investors, and despite the clear contrary teaching of *Piper* and *Lank,* the Trustee contends that he is entitled to sue here in Weis' own right, and SIPC that it is entitled to sue in its own right, under Section 17(a) (Trustee Br. 23-26; SIPC Br. 42-43). But obviously realizing the lack of merit to such contentions, they also seek to create the aura of being in the protected

class by purporting to represent Weis' public customers, with the Trustee contending that he (*i.e.*, Weis) is entitled to assert a claim as the "bailee" of the property of such customers (Trust. Br. 16-22) and SIPC that it may assert claims as the customers' "subrogee" (SIPC Br. 13, 42). Each of plaintiffs' contentions is without merit and must be rejected.

1. THE TRUSTEE MAY NOT ASSERT SECTION 17 CLAIMS IN WEIS' BEHALF. — Weis concededly was not a public investor, and therefore was not within the class which the 1934 Act and Section 17(a) were intended to protect. For this reason alone, and as Judge Wyatt recognized, such cases as *Piper* and *Lank* would bar Weis itself from asserting any implied right of action which might be assumed to exist under Section 17(a).

Moreover, Weis was a broker-dealer and, as such, was one of the class of broker-dealers which Section 17(a) and Rule 17a-5 were intended to regulate. That fact also compels the conclusion that Weis itself would not have any implied right of action under Section 17(a), under both *Piper* ("a party whose previously unregulated conduct was purposefully brought under federal control by the statute . . . can scarcely lay claim to the status of 'beneficiary' whom Congress considered in need of protection" — 430 U.S. at 37) and *Lank* (the 1934 Act was not enacted "for the purpose of affording protection to the very members of the stock exchanges whose conduct was being regulated" — 548 F.2d at 66). The SEC agrees, and in discussing *Piper* and *Lank*, it emphasizes that the Supreme Court in *Piper* "indicated that a member of the class Congress intended to regulate cannot assert a claim for damages based on violations of a statutory provision intended to benefit an entirely distinct class" (SEC Br. 14).

Since Weis would thus be barred from asserting any right of action under Section 17(a), the Trustee, who

purports to assert Weis' claims as "the representative of [the] defunct broker" in order to redress the "harm to the broker" (Trustee Br. 23, 26), is likewise barred (see also pp. 56-59, *infra*).

To avoid the effect of *Lank* (and presumably of *Piper*, which he does not discuss), the Trustee cites two decisions from "other circuits",[31] as well as Judge Lasker's decision in the District Court which this Court reversed in *Lank*, and contends that he is entitled here to assert a Section 17(a) claim on behalf of Weis for "the same reasons that led [those courts] to imply a right of action against a securities exchange for the representative of a defunct broker under Section 6" (Trustee Br. 23). In light of this Court's own decision in *Lank*, which unequivocally held that "the representative of a defunct broker" does not have any such "right of action", the Trustee's contention is an outright distortion of the applicable law and is blatantly frivolous. Indeed, the extent to which the Trustee is willing to go in support of his frivolous argument is shown by his *verbatim quotation of Judge Lasker's own rationale* for his reversed decision (the rationale that a brokerage firm, like its customers who do have an implied remedy under Section 6, must "rely" on its management to comply with the securities laws and exchange rules, and is "capable of sustaining damages as a result of violations" thereof) (Trustee Br. 23), without revealing that this Court's own decision in *Lank also quotes verbatim precisely the same passage setting forth Judge Lasker's rationale* and then goes on to flatly reject it:

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[31] One of the Trustee's cases, *Collins* v. *PBW Stock Exchange, Inc.*, 408 F.Supp. 1344 (E.D. Pa. 1976), is contrary to this Court's decision in *Lank* and is simply not good authority in this Circuit. His other case, *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135,143 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969), held only that where transactions arose out of a broker-dealer's violations of a New York Stock Exchange rule that were "tantamount to a fraud", the trustee in bankruptcy could set aside those transactions under Section 70(e) of the Bankruptcy Act.

> "*Belying this rationale,* however, is the fact that there is nothing in the language or legislative history of the [1934 Act] to indicate that Congress intended the protection of Section 6 to reach everyone who might rely on the Exchange's enforcement or suffer injury due to lack of it" (emphasis added). 548 F.2d at 66.[32]

Cf. *Blue Chip Stamps* v. *Manor Drug Stores, supra,* 421 U.S. at 738 (remedy under Section 10(b) unavailable to some persons who have in fact been damaged by violations thereof); see also *Miller* v. *New York Produce Exchange,* 550 F.2d 762, 768-769 and n.4 (2d Cir. 1977).

The Trustee also asserts that the "*Lank* rationale" — which he says "is not applicable to a suit against an accounting firm under Section 17" — is that the interests of broker-dealers and their public customers "may often be antagonistic" (Trustee Br. 24). Not only is the Trustee's assertion plainly wrong (the true rationale of *Lank* being that a broker-dealer is not a member of the protected class of public investors), but he also apparently seeks to use it as the premise for another erroneous argument — *viz.,* that if there is no such conflict of interests a broker-dealer need not be a member of the protected class of public investors in order to have an implied right of action under the 1934 Act, but rather need only be one whose interests "accord" with those of the protected class. Even as buttressed by the Trustee's

[32] The Trustee also makes the frivolous assertion that this Court's reversal in *Lank* was "on grounds irrelevant to a suit against an accountant" (Trustee Br. 23). The *Lank* holding that a broker-dealer and its trustee have no implied right of action because the broker-dealer is not a member of the protected class of public investors is certainly relevant — indeed, is controlling — with respect to any action by a broker-dealer or its trustee asserting an implied right of action, whether the action is against a stock exchange (as in *Lank*), against an accountant (as here), or against any other person or entity.

speculation that such a right of action "will only increase the incentives for the accountant properly to perform [its] duties . . . [and t]he protection of everyone who deals with a broker, including customers, would be enhanced" (Trustee Br. 25), the argument is simply unacceptable both in light of the actual holding in *Lank* and its reasoning:

> "Even were we to agree with appellee [Lank] that granting him a right of action against the Exchange would 'accord' with the purpose of the Exchange Act, our function here is to discern the intent of Congress, not to legislate in its place". 548 F.2d at 65.

2. SIPC MAY NOT ASSERT SECTION 17(a) CLAIMS ON ITS OWN BEHALF. — SIPC concededly was not a public investor and thus was not within the class of public investors which the 1934 Act and Section 17(a) were intended to protect. Therefore, as Judge Wyatt recognized, such cases as *Piper* and *Lank* bar SIPC from asserting any implied right of action which might be assumed to exist under Section 17(a).[33]

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[33] Even the SEC seems to concede that SIPC, since it is concededly not a public investor, is not entitled to assert a Section 17 claim on its own behalf. Thus, the SEC never asserts that SIPC has any such entitlement in its own right (see SEC Br. 5-16), but sees SIPC as having a Section 17 claim only as a subrogee of the customers of Weis, and emphasizes, for example, its view that "as subrogee of the customers of broker-dealers, SIPC's interest is identical to that of the customers", that "SIPC . . . stands in the shoes of the customers of the bankrupt broker" and that "the customers are the very class intended to be especially benefitted by [Section 17(a)], and SIPC, as a matter of law, succeeds to their interests as a result of its payments of their claims" (SEC Br. 13 n. 19, 15). Although the SEC errs in arguing that SIPC has Section 17 rights as a subrogee (see pp. 59-62, *infra*), the point here is that even the SEC concedes that SIPC has no Section 17 rights other than as a subrogee. Indeed, the SEC's only response to Judge Wyatt's observation that SIPC could not have been an intended beneficiary of Section 17 protection, since it was not created "until more than thirty years after Section 17" (407a), is to assert that this fact does not affect SIPC "as subrogee" (SEC Br. 13 n. 19).

SIPC's arguments are the same as those categorically rejected by such cases as *Piper* and *Lank*, and must be rejected here. SIPC argues that it "is a direct beneficiary of the duties imposed upon accountants by Section 17" because it "relies upon the Section 17 information certified by auditors" and "[a]n auditor's breach of its Section 17 duties . . . results in . . . consequent heavy costs to SIPC" (SIPC Br. 42-43, see also 4). SIPC's premise is that anyone who might rely upon a defendant's compliance with the 1934 Act or suffer injury due to lack of such compliance may assert an implied private right of action — a premise expressly rejected by this Court's holding in *Lank* that Congress did not intend to protect "everyone who might rely on . . . enforcement or suffer injury due to lack of it". 548 F.2d at 66. SIPC also argues that "[s]urely Congress did not intend that an auditor . . . should escape liability to SIPC" under Section 17(a) (SIPC Br. 43), an argument which falls far short of affirmatively demonstrating, as required by *Piper*, that there was a Congressional "intent to confer highly important new rights" upon SIPC or that SIPC itself is a "'beneficiary' whom Congress considered in need of protection". 430 U.S. at 30, 37. In creating SIPC, as in the case of enacting the 1934 Act itself, Congress spoke of directly benefitting the public investor only. See, *e.g.*, 116 Cong. Rec. 39350 (1970) (remarks of Rep. Moss).

3. THE TRUSTEE MAY NOT ASSERT SECTION 17 CLAIMS AS A PURPORTED "BAILEE" OF WEIS' CUSTOMERS. — The Trustee attempts to make it appear that he falls within the protected class of public investors by arguing that he asserts his Section 17 claim as a "bailee" of the property of Weis' customers (Trustee Br. 16-22). In support of his argument, the Trustee points to conclusory allegations of the complaint that as the result of Touche Ross' Section 17 violations there occurred "depletion of

the property held [by Weis] in trust for its customers"; contends that Weis, as bailee and therefore entitled to possession of the customers' property, had a sufficient interest therein to permit it to sue third parties for loss of or injury thereto; and therefore concludes that, since Weis thus could "stand in the customers' shoes", "the Trustee [now] 'stands in the place' of Weis' customer-bailors for purposes of bringing an action against Touche Ross" (Trustee Br. 16-17, 18, 21).[34]

The Trustee's "bailee" argument is nonsense and simply demonstrates that he does not understand the law of bailment. The common law doctrine upon which the Trustee purports to rely is that a bailee, because he is "entitled to the possession of the property bailed" and thus "has a special interest in it" (Trustee Br. 17), is entitled to sue third parties for interference with the bailee's own possessory rights with respect to the property. See generally PROSSER, LAW OF TORTS 94-95 (4th ed. 1971); HOLMES, THE COMMON LAW, Lectures V & VI, 130-194 (1963 ed.); 5 N.Y. JURISPRUDENCE, Bailment §§33-35, 117-119, particularly §118 ("The general rule is that either the bailee having a special property, or the bailor as general owner, may bring an action for the conversion or loss of, or injury to, the subject of the bailment. The right to sue is indispensable *to enable each to protect his particular interest*") (emphasis added) (1975 rev.). In other words, a bailee is entitled to sue to vindicate only *his own possessory rights*, not the rights of the bailor-owner, and therefore when the bailee does sue he is — to use the

[34] In other words, the Trustee asserts that he is a "bailee" because Weis was a "bailee" and that he simply takes the place of Weis. That assertion results from the fact that, under SIPA, the Trustee has the same title to property and powers as a bankruptcy or Chapter X trustee, 15 U.S.C. §78fff(b)(1), Trustee has no standing himself to assert claims of customers. See, *e.g.*, *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972); *In re Petroleum Corp. of America*, 417 F.2d 929 (8th Cir. 1969); *King* v. *Sharp*, 63 F.R.D. 60 (N.D. Texas 1974).

trustee's metaphor — not "standing in the shoes of the bailor" (*i.e.*, not suing to protect the bailor's rights) but instead "standing in his own shoes" (*i.e.*, suing to protect his own bailee's rights).[35] Since Weis as bailee (and therefore the Trustee standing in Weis' place) could assert only its own rights, it clearly could not sue with respect to those rights under Section 17(a), not being a member of the class sought to be protected thereby (see pp. 52-55, *supra*).

Moreover, the Trustee's claim here — a claim which is described only in his brief and not in the obscure allegations of the complaint upon which it purportedly is premised — is that the fund of customers' property held by Weis as bailee was depleted as a result of *Weis itself having converted such property to its own use* (Trustee Br. 21-22). The common law doctrine which permits a bailee to sue to protect its own possessory interest in the bailed property is obviously inapplicable to a bailee, such as Weis, which has itself converted the bailed property to its own use and accordingly has suffered no interference with its own possessory right as bailee.

Weis thus cannot properly be said to "stand in the shoes" of its customers for purposes of asserting their purported claims against Touche Ross. The Trustee likewise does not, and no talk of "benefit" to the customers can justify permitting him to sue here. Cf. *Lank* v. *New York Stock Exchange, supra,* 548 F.2d at 67 ("To the

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[35] The Trustee would mislead when he cites *Baldwin* v. *Hill,* 315 F.2d 738, 742 (6th Cir. 1963), from which he quotes to establish his alleged proposition that "[w]ith respect to third persons, [the bailee] stands in the place of the owner" (Trustee Br. 17). What the Trustee fails to reveal is that *Baldwin* v. *Hill* does not hold that a bailee may sue third parties on claims belonging to the owner and as the owner's legal representative, but rather that under the Michigan automobile "guest passenger statute" a bailee-passenger is to be considered as the "host" (that is, the "owner") rather than as a "guest"!

extent that a receiver's recovery in a Section 6 suit would benefit public investors . . . those investors already have a cause of action in their own right . . . and the receiver's suit would add nothing to their rights").[36]

4. SIPC MAY NOT ASSERT SECTION 17 CLAIMS AS A PURPORTED "SUBROGEE" OF WEIS' CUSTOMERS. — Without citing any authority, and without providing any supporting analysis, SIPC contends that it is "the subrogee of the customers of Weis whose claims were satisfied through the depletion of the SIPC fund" and is subrogated to the customers' purported "cause[s] of action under Section 17 against Touche Ross" (SIPC Br. 2, 32). SIPC's contention is erroneous.

SIPC has no subrogation rights with respect to, and is not a subrogee of, any claim against Touche Ross, because Section 6 of SIPA itself provides an express — and exclusive — subrogation right to SIPC, and that right extends only to those "claims" which customers have against the debtor's estate and does not extend to customer causes of action against third parties such as Touche Ross. Even the SEC here concedes that the statutory subrogation rights provided to SIPC in Section 6 of SIPA extend only to customer claims "against the broker-dealer" (SEC Br. 13). Those subrogation rights are expressly provided in Section 6(f)(1), 15 U.S.C. §78fff(f)(1):

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[36] *Dictum* in *Securities & Exchange Commission* v. *Albert & McGuire Securities Co., Inc.*, ___ F.2d ___, CCH Fed. Sec. L. Rep. ¶96,129 (3d Cir. 1977), suggests that in some circumstances a SIPA trustee may obtain assignments from customers of their claims against third parties (claims which there arose under State law) and sue as assignee, a proposition which (even if it were correct) would be irrelevant here since the Trustee does not purport to have received any such assignment or to sue as assignee. The same *dictum* also erroneously suggests in passing that SIPC is subrogated to such customers' claims against third parties, but offers no authority or analysis in support of the suggestion, which in fact is inconsistent with the proposition under discussion there, *viz.*, that an actual assignment of the claims to the trustee (not SIPC) would be necessary.

> "To the extent that moneys are advanced by SIPC to the trustee to pay the claims of customers, SIPC shall be *subrogated to the claims of such customers with the rights and priorities provided in this section*" (emphasis added).

The "claims" to which SIPC is subrogated under section 6(f)(1) include only claims of customers against the estate of the debtor (*i.e.*, Weis). The term "claims" is used uniformly throughout Section 6 of SIPA to include claims against the debtor's estate only,[37] and it is a settled principle of statutory construction that when the same

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[37] For example, Section 6(g), 15 U.S.C. §78fff(g), provides that "It shall be the duty of the trustee to discharge promptly . . . *all obligations of the debtor* to each of its customers . . . whether or not such customer shall have filed formal proof of *such claim*" and goes on to provide, *inter alia*, for payments to be made by the trustee "in respect of *claims relating to securities or cash*" and "in respect of *claims . . . which are ascertainable from the books and records of the debtor*" (emphasis added). As another example, Section 6(c)(2)(A)(ii),15 U.S.C. §78fff(c)(2)(A)(ii), defines "'customers' of a debtor" as "persons . . . who have *claims* on account of securities received, acquired, or held by *the debtor* from or for the account of such persons . . . includ[ing] persons who have *claims against the debtor* arising out of sales or conversions of such securities" (emphasis added). For further examples, see Section 6(c)(2)(B), 15 U.S.C. §78fff(c)(2)(B) ("*claims* payable from such single and separate fund," which fund consists of "property . . . received, acquired, or held by . . . a *debtor* from or for the account of customers"); Section 6(c)(2)(D), 15 U.S.C. §78fff(c)(2)(D) ("[w]here such single and separate fund is not sufficient to pay in full the *claims* of such single and separate class of creditors"); Section 6(e), 15 U.S.C. §78fff(e) ("*claims* for specifically identifiable property . . . or *claims* payable from property in the single and separate fund or payable with moneys advanced by SIPC, *shall not be paid other than from the general estate of the debtor* unless filed within such period of time . . . as may be fixed by the court", and "the court may make appropriate provision for proof and enforcement of *all claims against the debtor including those of any subrogee*"); Section 6(h), 15 U.S.C. §78fff(h) ("discharge of *obligations of the debtor* to pay cash or to deliver securities without formal proof of *claim*"); Section 6(j), 15 U.S.C. §78fff(j) ("nothing in this section shall limit the right of any person to establish by formal proof such *claims* as such person may have to payment, or to delivery of specific securities, without resort to moneys advanced by SIPC to the trustee") (emphasis added).

word or phrase is used in the same section of a statute more than once, and the meaning is clear in one place, it will be construed to have the same meaning in the other places. *E.g., Meyer* v. *United States,* 175 F.2d 46, 47 (2d Cir. 1949); *United States* v. *Vargas,* 380 F.Supp. 1162, 1166 (E.D.N.Y. 1974); cf. *United States* v. *Cooper Corp.,* 312 U.S. 600, 606 (1941) (different sections of same act). Moreover, Section 6(f)(1) itself, which provides that SIPC is "subrogated to the *claims* of such customers", makes clear that "the claims" to which SIPC is subrogated are "the claims of customers" which are referred to in the introductory clause and for payment of which "moneys are advanced by SIPC to the trustee". Furthermore, to include within the term "claim" causes of action against persons other than the debtor would render totally inapposite the qualification in Section 6(f)(1) that "SIPC shall be subrogated . . . *with the rights and priorities provided in this section*" (emphasis added).

To construe the term "claims" as including customer causes of action against third parties would also conflict with the pertinent legislative history, authorities, and law review commentaries.[38] It also would conflict with the express definition in the Bankruptcy Act of the term "claims" — a definition which is pertinent, if not con-

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[38] See *e.g.,* House Report No. 91-1613, reprinted in [1970] U.S. Code Cong. & Adm. News 5254, 5262 ("SIPC would advance to the trustee such sums from the SIPC fund as would be necessary to provide for prompt *payment of claims of customers* . . . . It is, of course, hoped and contemplated that, when the liquidation proceedings are completed, SIPC will receive back some moneys *from the trustee*"); *Securities and Exchange Commission* v. *Aberdeen Securities Co., Inc.,* 480 F.2d 1121, 1124 (3d Cir.), *cert. denied,* 414 U.S. 1111 (1973) ("*To the extent that a claim is satisfied* by advances from SIPC, it is subrogated to the customer's rights *to a pro rata share of the single and separate fund*"); *Securities and Exchange Commission* v. *S. J. Salmon & Co.,* 375 F.Supp. 867, 871 n.12 (S.D.N.Y. 1974) ("To the extent that a *customer's claim is satisfied* by advances from SIPC, SIPC is subrogated to *the claims of such customer against the debtor's property*"); Guttman, *Broker-Dealer Bankruptcies,* 48 N.Y.U. L. Rev. 887, 956 (1973) ("[S]ection 6(g)(1) enables the trustee to draw upon the SIPC Fund even if it is clear that there are insufficient assets

trolling, under SIPA.[39] Section 106(1) of the Bankruptcy Act, 11 U.S.C. §506(1), defines "claims" as follows: "'claims' shall include all claims of whatever character *against a debtor or its property*, except stock" (emphasis added). See COLLIER ON BANKRUPTCY ¶2.05, p. 307 ("To come within the terms of §106(1) . . . it is *essential that the claim in question be predicated against either the debtor or the debtor's property*") (emphasis added).

In light of the comprehensive statutory scheme established by SIPA, it is also clear that Congress intended that SIPC's express statutory subrogation to customer "claims" against the estate of the debtor be SIPC's exclusive subrogation remedy. See, *e.g.*, *Amtrak*, *supra*, 414 U.S. at 458 ("when legislation expressly provides a particular remedy or remedies, courts should not expand the coverage of the statute to subsume other remedies"); *Rogers* v. *Nat'l Surety Co.*, 116 Neb. 170, 216 N.W. 182 (1927) (under statute establishing a "depositor's guaranty fund", express provision subrogating such fund to the rights of creditors paid by the fund to participate in the assets of the defunct bank held, under *expressio unius* principle, to be fund's exclusive subrogation remedy). See also House Report No. 91-1613, *supra*, [1970] U.S. Code Cong. & Adm. News at 5262 ("It is . . . contemplated that, when the liquidation proceedings are completed, SIPC will receive back some moneys *from the trustee*" (emphasis added)).

* * *

Thus, neither the Trustee nor SIPC is a member of, or entitled to assert any claim belonging to, the class of public investors intended to be protected by the 1934 Act,

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in the debtor's estate to replenish the fund through subrogation . . . . SIPC is entitled to *subrogation to the rights of such customer in the final distribution of the single and separate fund and in the general estate*, should the single and separate fund be insufficient to cover the claims of customers") (emphasis added).

[39] See Section 6(c)(1) of SIPA, 15 U.S.C. § 78fff(c)(1).

and therefore neither of them may obtain relief against Touche Ross under Section 17(a).

B. Section 17(a) Imposes No Duty Upon Accountants Such As Touche Ross.

The language of Section 17(a) does not refer to, and does not impose any duty upon, accountants such as Touche Ross who have allegedly audited and certified financial statements filed pursuant thereto. As Judge Wyatt held,

> "Section 17 does not impose any duty on accountants. It specifically mentions a 'national securities exchange', the members thereof, a 'registered securities association', brokers, and dealers; it does not mention accountants. While the regulations do contain provisions respecting an accountant's certificate . . . the oath is only by the broker or dealer" (407a-408a).

Judge Wyatt also cited *Rothstein* v. *Seidman & Seidman*, 410 F. Supp. 244, 248 (S.D.N.Y. 1976), in which Judge Weinfeld held that a "special instruction" to a New York Stock Exchange audit rule, the "specific language" of which imposed a reporting duty on the "member or member organization", did not "impos[e] any duty on the auditing accountant from which a private right to damages could be implied." See also *In re Equity Funding Corp. of America Securities Litigation, supra*, 416 F. Supp. at 190.

Recognizing the correctness of Judge Wyatt's observation that Section 17(a) itself "does not mention accountants", the Trustee and SIPC emphasize Rule 17a-5's requirement that certain reports be audited (Trustee Br. 14; SIPC Br. 26). However, as Judge Wyatt also recognized, while Rule 17a-5 does mention accountants it does not impose any duty upon accountants. Moreover, a contrary interpretation of Rule 17a-5 would be impermissible because Section 17(a) itself imposes no duty on

accountants, and it is well-established that "the language of the statute must control the interpretation of the Rule". *Santa Fe Industries, Inc.* v. *Green, supra,* 45 U.S.L.W. at 4320; see also *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 214 ("[The] scope [of the rule] cannot exceed the power granted the Commission by Congress"). Further, it is clear that any ambiguity as to whether Rule 17a-5 does in fact impose a duty upon accountants would itself require a finding that no private right of action be implied thereunder against accountants. Cf. *Drasner* v. *Thomson McKinnon Securities, Inc.*, CCH Fed.Sec.L.Rep. ¶96,080 at pp. 91,887-91,888 (S.D.N.Y. 1977).

Since Section 17(a) and Rule 17a-5 impose no duty on Touche Ross, plaintiffs' Section 17 claims fail to state a claim for relief against Touche Ross and were properly dismissed.[40]

C. The Complaint Fails To Allege The Necessary Scienter On The Part Of Touche Ross.

Although it was unnecessary for Judge Wyatt to reach the *scienter* question, it is clear that *scienter* is a necessary element of any private right of action which might be assumed to exist under Section 17(a). In *Ernst & Ernst* v.

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[40] Plaintiffs cannot avoid the fact that Section 17(a) imposes no duty on Touche Ross simply by alleging that Touche Ross "aided and abetted" violations of Section 17(a) committed by Weis' officers. Decisions under other sections of the 1933 and 1934 Acts which specifically address themselves to a limited class of persons hold that "aiding and abetting" allegations are insufficient to impose liability upon defendants who do not fall within the limited class. See, *e.g., In re Equity Funding Corp. of America Securities Litigation, supra,* 416 F. Supp. at 181 ("This court is of the opinion that where a statute specifically limits those who may be held liable for the conduct described by the statute, the courts cannot extend liability, under a theory of aiding and abetting, to those who do not fall within the categories of potential defendants described by the statute. To impose such liability would circumvent the express intent of Congress in enacting these statutes that proscribe narrowly defined conduct and allow relief from precisely defined parties"); *Barlas* v. *Bear, Stearns & Co.*, CCH Fed. Sec. L. Rep. ¶91,674, at pp. 95,477-95,478 (N.D. Ill. 1966). The "aiding and abetting" theory also is untenable here because of the absence of any allegation of *scienter* (see pp. 67-68 n. 45, *infra*).

Hochfelder, supra, the Supreme Court, in holding that *scienter* was an essential element in a private action for damages under Section 10(b) and Rule 10b-5, observed that the "1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities", and went on to state that

> "it [is] significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct . . . is subject to significant procedural restrictions not applicable under § 10(b) . . . . We think these procedural limitations indicate that the judicially created private damages remedy under §10(b) — which has no comparable restrictions — cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing." 425 U.S. at 206, 208-210 and n.30.

The restrictions to which the Court referred include authorization for a district court to require plaintiffs to post a bond for costs (including attorneys' fees) and to assess costs at the conclusion of the litigation, and a short statute of limitations. The Court's conclusion in *Hochfelder* that it would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions [for damages for negligent conduct]" to permit actions under Section 10(b) and Rule 10b-5 absent *scienter* applies equally as well to private actions (if any there be) under Section 17(a), because that section and the rules thereunder, like Section 10(b) and Rule 10b-5, obviously do not contain any of the "carefully drawn procedural restrictions" which Congress deemed necessary in the express provisions allowing recovery for negligent conduct. The *Hochfelder* opinion also noted that there was no substantial support in the legislative history for permitting implied actions grounded on negligence, pointing, significantly, to the fact that the originally proposed version of Section 18(a) (which provides the express remedy for violations

of reporting provisions such as Section 17(a)) would have imposed liability for negligence, and that Section 18(a) was changed in subsequent bill drafts so as to eliminate liability for negligence after "[t]he accounting profession objected to [the original] provision on the ground that liability would be created for honest errors in judgment". 425 U.S. at 212 n. 31.[41] The reasoning of *Hochfelder* thus requires that *scienter* be a necessary element of any private right of action under Section 17(a).

The complaint here alleges that Touche Ross performed its services in a "negligent, reckless, careless, unskilled and grossly negligent manner" (Comp. ¶28, see also ¶¶42, 84), that Touche Ross failed to conduct its audit in accordance with generally accepted auditing standards and accounting principles (Comp. ¶31), that Touche Ross' conduct was "negligence per se" (Comp. ¶37) and "malpractice" (Comp. ¶¶39, 72, 76, 80, 82, 84), that Touche Ross "knew or should have known" that Weis' financial statements were false (Comp. ¶41, see also ¶¶60, 65, 80, 82), that Touche Ross failed to render services "in a thorough, proper, skillful and diligent manner" (Comp. ¶45), and that Touche Ross "*would have discovered*" the fraud perpetrated by the Weis Five if it had "audited, verified and examined" Weis' financial statements "in accordance with generally accepted auditing standards, generally accepted accounting principles, and [unspecified] audit regulations of the Exchange and the SEC" (Comp. ¶29(a), (b)). Those allegations do not set forth the necessary *scienter*, but simply charge negligence. This is clear not only from the language of the allegations themselves, but also from *Hochfelder*, where practically identical allegations (which were held not to constitute *scienter*) charged Ernst & Ernst with " 'failure' to conduct proper audits of First Securities" and were

[41] The Court in *Hochfelder* also noted that "[e]ach of the provisions of the 1934 Act that expressly create civil liability, except . . . §16(b) . . ., contains a state-of-mind condition requiring something more than negligence". *Id.* at 209 n.28.

based on the premise that "Ernst & Ernst had failed to utilize 'appropriate auditing procedures'" and that "if Ernst & Ernst had conducted a proper audit, it would have discovered th[e] 'mail rule'" by which the broker-dealer's president implemented the fraudulent scheme. 425 U.S. at 190.[42]

Plaintiffs themselves confirm in their briefs that the complaint alleges only negligence and that no *scienter* is charged. Thus, not only do they refer to Touche Ross' conduct in negligence terms,[43] but they go so far as to concede in so many words that "[e]ssentially, both plaintiffs allege that Touche Ross was *negligent*" (emphasis added) (Trustee Br. 10).[44]

Thus, there being no *scienter*, any assumed implied right of action under Section 17(a) may not be maintained.[45]

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[42] See also *Rich* v. *Touche Ross & Co.*, *supra*, 415 F.Supp. at 101, where, in dismissing the action by Weis' customers against Touche Ross based upon the same matters asserted in the complaint here, Judge Brieant noted that the allegations of the second amended complaint were insufficient to change *scienter*, particularly in light of the fact that the indictment against the Weis officers pointed out (and it was admitted by guilty pleas) that the officers had concealed their wrongdoing from Touche Ross (see p. 12, *supra*).

[43] For example, plaintiffs assert that "[t]hese false entries [were] *undetected by Touche Ross*" (Trustee Br. 8); that "[t]he [c]omplaint alleges that had Touche Ross conducted a competent audit and examination of Weis' system of internal control . . . it could not have failed to discover these misstatements" (*id.*); that "[i]n the complaint, plaintiffs sought to recover the damages suffered as a direct result of the failure of . . . Touche Ross . . . to properly perform certain accounting services" (SIPC Br. 2); and that "[h]ad Touch Ross conducted its audit in the manner in which it represented in its opinion letter . . . it *would have discovered* the mammoth fraud perpetrated by Weis' officers" (*id.* at 11) (emphasis added).

[44] The SEC recognizes the need for *scienter* and limits its argument that a private right of action may be implied under Section 17(a) in favor of SIPC to "willful violations of that provision" (SEC Br. 16). The SEC erroneously asserts, without any support, and contrary to plaintiffs' own views, that *scienter* is alleged here (SEC Br. 21 n.31).

[45] The complaint's allegations of negligence, and not *scienter*, also are fatal to its conclusory "aiding and abetting" allegations. It is clear that a defendant may not be held liable for "aiding and

III

The District Court Correctly Held That There Is No Pendent Jurisdiction Over Plaintiffs' Common Law "Causes Of Action"

As Judge Wyatt correctly recognized (408a), the fact that plaintiffs' Section 17(a) "causes of action" fail to state a claim upon which relief can be granted means that there is no pendent jurisdiction over their common law "causes of action". *E.g., United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966); *Kavit* v. *A. L. Stamm & Co.*, 491 F.2d 1176 (2d Cir. 1974). Plaintiffs concede that as long as Judge Wyatt's dismissal of their Section 17(a) "causes of action" is not reversed, there is no basis for the exercise of pendent jurisdiction (SIPC Br. 5 n.; Trustee Br. 26-27).

Moreover, even assuming *arguendo* that either of plaintiffs could somehow assert a Section 17(a) claim, it does not necessarily follow that pendent jurisdiction over his or its common law "causes of action" should be exercised. The common law "causes of action" are the subject of, and are being actively litigated in, the State Court Action, and it simply does not serve the purpose of the pendent jurisdiction doctrine to use it to secure jurisdiction over claims already pending in the State Court, particularly where the determination of such claims turns solely on issues of State law and where plaintiffs themselves commenced the State Court Action. If pendent jurisdiction were exercised here, Touche Ross "would

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abetting" absent a showing of actual knowledge and wrongful intent. *E.g., H.L. Federman & Co.* v. *Greenberg*, 405 F.Supp. 1332, 1336-1337 (S.D.N.Y. 1975); *Rosen* v. *Dick*, CCH Fed. Sec. L.Rep. ¶94,786, at p. 96,604 (S.D.N.Y. 1974). In *Hochfelder*, the Supreme Court, in reversing the Seventh Circuit's holding that an accounting firm was liable for "aiding and abetting" another's violation of Rule 10b-5, stated that it was unnecessary to reach the issue of whether liability could be imposed for "aiding and abetting", because in the absence of *scienter* liability could not be imposed under the statute. 425 U.S. at 192 n.7. "The aiding and abetting" theory also is improper here because Section 17(a) imposes no duties on accountants who thus may not be held liable thereunder (see pp. 63-64, *supra*).

be forced to defend against the same [common law] claims[s] in both the Federal and state courts" and "[s]uch a result would not further the interest in 'judicial economy' and 'fairness to litigants,' but would rather be seriously inimical to the considerations upon which the doctrine of pendent jurisdiction is based." *Remington* v. *Remington*, 393 F.Supp. 898, 902 (E.D. Pa. 1975); cf. *Cole* v. *Schenley Industries, Inc.*, ___ F.2d ___, Slip Op. 5853, 5870 (2d Cir. Sept. 9, 1977).[46]

Absent pendent jurisdiction, there is no subject matter jurisdiction here over plaintiffs' common law "causes of action". As already noted (p. 4 n.10, *supra*), SIPC has abandoned its erroneous claim of diversity jurisdiction. And as demonstrated in the following Point IV of this brief, the Trustee's claim that there is bankruptcy jurisdiction over his common law "causes of action" is erroneous.

IV

The District Court Correctly Held That It Has No Bankruptcy Jurisdiction Over The Trustee's Common Law "Causes Of Action"

The Trustee contends that the District Court has bankruptcy jurisdiction of his common law "causes of action" under "Sections 5 and 6 of SIPA (15 U.S.C. §§78eee and 78fff) and Sections 2a(7), 102 and 115 of the Bankruptcy Act (11 U.S.C. §§11(a)(7), 502 and

[46] Citing *Almenares* v. *Wyman*, 453 F.2d 1075 (2d Cir. 1971), *cert. denied*, 405 U.S. 944 (1972), the Trustee erroneously contends that "if only one of the plaintiffs stated a federal claim under Section 17, it would be proper . . . to exercise pendent jurisdiction over the state-law claims of the other [plaintiff]" (Trustee Br. 26 n.7). Although in *Almenares*, this Court upheld the use of pendent jurisdiction to join with defendants against whom federal claims were asserted another defendant against whom no such claims were alleged, the Supreme Court has subsequently held that it is improper to assume federal jurisdiction over the claims of plaintiffs who do not demonstrate independent grounds for federal jurisdiction, even when their claims are similar to those of plaintiffs whose claims are properly before the court, *Zahn* v. *International Paper Co.*, 414 U.S. 291 (1973), and more recently has spoken disapprovingly of the doctrine of "pendent parties" as an improper extension of the principle of pendent jurisdiction, *Aldinger* v. *Howard*, 427 U.S. 1, 14-15 (1976).

515), as made applicable by SIPA" (Trustee Br. 27).[47] Judge Wyatt held, however, that "[t]he situation at bar . . . is controlled by [Section 23 of the Bankruptcy Act] 11 U.S.C. §46 which provides that a trustee in bankruptcy may sue only in the courts where the bankrupt might have sued" (408a), and that subject matter jurisdiction of the Trustee's common law "causes of action" is lacking because there would have been no diversity jurisdiction in an action between Weis and Touche Ross (410a).[48] As shown hereinafter, Judge Wyatt correctly concluded that Section 23 is applicable and controlling here, and that the Trustee's jurisdictional arguments "cannot be accepted" (409a).

A. Section 23 Of The Bankruptcy Act, Which Is Incorporated Into SIPA By Section 6(c)(1) Thereof, Controls Here And Operates To Deprive The District Court Of Jurisdiction.

1. SECTION 23 OF THE BANKRUPTCY ACT. — Section 23 of the Bankruptcy Act, 11 U.S.C. §46, limits a district court's subject matter jurisdiction over an action brought by a trustee against another party (an "adverse claimant"), by providing that such jurisdiction exists only to the extent that, had the bankruptcy proceeding not been instituted, there would have been jurisdiction if the action were between the bankrupt and the other party.[49] From

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[47] The complaint alleges all of the sections here specified by the Trustee, except Section 5 of SIPA (Comp. ¶2).

[48] Judge Wyatt noted that "[i]t seems undisputed that the principal place of business of Weis (28 U.S.C. §1332(c)) was in New York and that members of the Touche [Ross] firm are citizens of New York" (410a; see also 168a[¶5], 289a-290a). The Trustee does not, as he cannot, challenge that finding.

[49] Section 23 of the Bankruptcy Act provides as follows:

"§23. *Jurisdiction of United States and State Courts.* a. The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings under this Act, between receivers and trustees as such and adverse claimants, concerning the property acquired or claimed by the receivers or trustees, in the same manner and to the same extent as though such proceedings had not been instituted and

its first interpretation in the Supreme Court, only two years after its enactment, Section 23 has been held to be a strict limitation on the plenary jurisdiction of the district courts, and to reflect a Congressional intention to direct plenary actions by trustees to the State courts. See, *e.g.*, *Bardes* v. *Hawarden Bank*, 178 U.S. 524, 538 (1900); *Kelley* v. *Gill*, 245 U.S. 116 (1917); *Schumacher* v. *Beeler*, 293 U.S. 367, 374 (1934); *Williams* v. *Austrian*, 331 U.S. 642, 649 (1947). As the Supreme Court explained, for example, in *Schumacher* v. *Beeler*,

> "In enacting §23, it was clearly the intent of the Congress that the federal courts should not have the unrestricted jurisdiction of suits between trustees in bankruptcy and adverse claimants which these courts had exercised under the broad provisions of §2 of the Act of 1867 [an earlier bankruptcy act]. The purpose was to leave such controversies to be heard and determined for the most part in the state courts 'to the greater economy and convenience of litigants and witnesses.'" 293 U.S. at 374.

2. SECTION 6(c)(1) OF SIPA, AND ITS INCORPORATION OF SECTION 23 BY REFERENCE TO SECTION 102 OF THE BANKRUPTCY ACT. — Section 6(c) of SIPA, which is entitled "Application of Bankruptcy Act", provides for the incorporation of Section 23 of the Bankruptcy Act into SIPA, by reference to Section 102 of the Bankruptcy Act, as follows:

> "(1) General provisions applicable. Except as inconsistent with the provisions of [SIPA] and except that in no event shall a plan of reorganization be formulated, a liquidation proceeding shall be conducted in

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such controversies had been between the bankrupts and such adverse claimants.

"b. Suits by the receiver and the trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this Act had not been instituted, unless by consent of the defendant". 11 U.S.C. §46.

> accordance with, and as though it were being conducted under, the provisions of chapter X and *such of the provisions* . . of chapters I to VII, inclusive, of the Bankruptcy Act *as* [*Section 102 of the Bankruptcy Act*] *would make applicable if an order of the court had been entered directing that bankruptcy be proceeded with* pursuant to the provisions of such chapters I to VII, inclusive" (emphasis added). 15 U.S.C. §78fff(c)(1).

Section 102 of the Bankruptcy Act (which is part of Chapter X, dealing with corporate reorganizations) expressly provides that Section 23 will apply when an order of the type referred to in Section 6(c)(1) of SIPA (*i.e.*, an order "directing that bankruptcy be proceeded with") is entered, as follows:

> "The provisions of chapters 1 to 7, inclusive, of [the Bankruptcy Act] shall, insofar as they are not inconsistent or in conflict with the provisions of this chapter, apply in proceedings under this chapter: *Provided, however*, That [*section 23* and portions of three other sections] *shall not apply in such proceedings unless an order shall be entered directing that bankruptcy be proceeded with* pursuant to the provisions of chapters 1 to 7, inclusive" (emphasis added). 11 U.S.C. §502.

Thus, the combination of Section 6(c)(1) of SIPA and Section 102 of the Bankruptcy Act operates to make Section 23 of the Bankruptcy Act applicable in every SIPA liquidation proceeding. Section 102 provides that Section 23 is to apply when "an order shall be entered directing that bankruptcy be proceeded with", and Section 6(c)(1) provides that those provisions of the Bankruptcy Act are applicable to a SIPA liquidation that Section 102 "would make applicable if an order . . . had been entered directing that bankruptcy be proceeded with". See *Securities and Exchange Commission* v. *Morgan Kennedy & Co., Inc.*, CCH Fed.Sec.L.Rep. ¶94,568 at p. 95,966 (S.D.N.Y.

1974); 6 COLLIER ON BANKRUPTCY ¶1.06, p. 209. This means, of course, that any action commenced by a SIPA trustee is subject to Section 23 and its express restrictions on bankruptcy jurisdiction and must therefore have some independent basis for federal jurisdiction — *e.g.*, diversity of citizenship between the defunct broker-dealer and the defendant.

The Trustee errs in contending that the reference in Section 6(c)(1) of SIPA to Section 23 is "circuitous" (*i.e.*, by means of a reference to Section 102, rather than by means of a direct reference to Section 23) and therefore was unconscious or unintentional (Trustee Br. 30 n.10). The specific reference in Section 6(c)(1) to Section 102, and to those "provisions" which Section 102 would make applicable under an order to proceed with bankruptcy, evidences a specific Congressional intent, *viz.*, that no matter what else might be incorporated, the "provisions" (which are four specified sections, including Section 23) expressly referred to in Section 102 are to apply in a SIPA liquidation. This was clearly recognized, for example, in *Exchange Nat'l Bank* v. *Wyatt*, 517 F.2d 453, 458 (2d Cir. 1975), where this Court, in construing the "provisions" incorporated into SIPA by Section 6(c)(1)'s reference to Section 102, noted the "specific direction [of Section 102] that the few sections of chapters I to VII expressly made inapplicable to chapter X proceedings prior to such an order shall become applicable when such an order has been made." Of course, one of the "few sections" which this Court recognized as thus made fully applicable under SIPA is Section 23.[50]

[50] The Trustee concedes that "Section 23 would play some role in SIPA liquidations" (Trustee Br. 35), but offers no plausible explanation as to why Section 23 should not be fully applicable. He suggests at one point that Section 23 might "imply a limitation on the summary jurisdiction of the Bankruptcy Judge but not on the plenary jurisdiction of the district court" (*id.* at n.11), a suggestion which evidences a complete misconception of the purpose and effect of Section 23. See 2 COLLIER ON BANKRUPTCY ¶ 23.03 ("the power of a bankruptcy court to act summarily . . . is not in any way restricted by

3. THE UNAVAILABILITY IN A SIPA LIQUIDATION OF THE BROAD PLENARY JURISDICTION EXERCISED UNDER SECTION 2a(7) OF THE BANKRUPTCY ACT IN CHAPTER X REORGANIZATIONS. — The Trustee cannot avoid the jurisdictional limitations imposed by Section 23 in SIPA liquidations by asserting that in a Chapter X proceeding "the district court has unlimited subject matter jurisdiction under Section 2a(7) of the Bankruptcy Act over all suits" by a Chapter X trustee (Trustee Br. 29). Examination of Section 2a(7) and its intended function in a Chapter X reorganization proceeding merely serves to emphasize the

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the terms of §23"). At another point he asserts that Section 23 is incorporated only insofar as it concerns "administrative claims processing" and not jurisdiction, because the other Bankruptcy Act provisions which Section 102 specifically suspends during a Chapter X reorganization purportedly "deal with administrative matters", and thus the similar suspension of Section 23 must have had something to do with some "administrative" aspect of Section 23 (Trustee Br. 30 n.10). In fact, the enumeration in Section 102 of specific sections which were suspended during reorganization has nothing to do with whether those sections are "administrative" — they are enumerated only because there was some doubt whether they were inconsistent with the provisions for reorganization in Chapter X and it was desired to make clear that they would not apply in a Chapter X reorganization. *Williams* v. *Austrian*, *supra*, 331 U.S. at 654-655 n.28. The Trustee also asserts that even though Section 23 is incorporated, "uniformity of practice and expertise in federal securities law" argue for federal court jurisdiction of plenary actions such as the present one (Trustee Br. 30 n.10). Aside from the fact that the Trustee here seeks to establish bankruptcy jurisdiction over his common law claims (not his securities law claims), no court has ever suggested that his factors might override the strict proscription of Section 23. In fact, since federal jurisdictional statutes are to be read narrowly, see 1 MOORE'S FEDERAL PRACTICE ¶0.60[3], pp. 620-621 (1977), such factors would only have relevance where the jurisdictional statute in question has as its purpose uniformity and expertise in federal securities law. Obviously Section 23, enacted 35 years before there was such a thing as federal securities law, has no concern with that later jurisprudence; and since the intent of Section 23 was to establish a preference for State court adjudication of State law claims, it is equally clear that uniformity of practice was antithetical to its goal. In enacting Section 23, Congress "chose to leave such litigation to the appropriate local practice and local rules concerning jury trial in the local court, and at the same time to relieve thereby an overworked federal judiciary." *Williams* v. *Austrian*, *supra*, 331 U.S. at 670-671 (Frankfurter, J., dissenting).

function of Section 23 and its strict limitation on the scope of the district court's jurisdiction in a SIPA liquidation.

Section 2a(7) has been held to be the basic jurisdictional provision of the Bankruptcy Act, conferring jurisdiction with respect to both summary proceedings and plenary actions.[51] *Williams* v. *Austrian, supra.* However, Section 2a(7) contains the important phrase "except as herein otherwise provided", a phrase which the Supreme Court has consistently held to be a reference to Section 23, which section therefore necessarily limits the jurisdiction conferred by Section 2a(7). *Williams* v. *Austrian, supra,* 331 U.S. at 649; *First National Bank* v. *Title & Trust Co.,* 198 U.S. 280, 298 (1905); *Bryan* v. *Bernheimer,* 181 U.S. 188, 194 (1901); *Bardes* v. *Hawarden Bank, supra,* 178 U.S. at 535-536.

By virtue of Section 102, Section 23 is inapplicable in Chapter X reorganization proceedings, but only as long as the reorganization itself is going forward (that is, in the words of Section 102, until "an order shall be entered directing that the bankruptcy be proceeded with"). Thus, where no such order has been entered, Section 2a(7) provides Chapter X reorganization courts with jurisdiction "to hear plenary suits brought by a reorganization trustee, even though diversity or other usual ground for federal jurisdiction is lacking"; this "extend[s] the jurisdiction of the reorganization courts beyond that exercised by ordinary bankruptcy courts". *Williams* v. *Austrian, supra,* 331 U.S. at 657-658, 661. *Accord, Rochelle* v. *Marine Midland Grace Trust Co.,* 535 F.2d 523 (9th Cir. 1976).

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[51] Section 2a(7) provides as follows:

"a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested . . . with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, . . . to —

"(7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, *except as herein otherwise provided*" (emphasis added).

The expansion of jurisdiction for Chapter X courts resulting from the enactment of Section 102 and its suspension of Section 23 in Chapter X reorganizations as long as reorganization is proceeding — an expansion which effected a substantial revision in prior law, *e.g.*, *Williams* v. *Austrian, supra,* 331 U.S. at 661; 6 COLLIER ON BANKRUPTCY ¶1.06[1], p. 210 — had as its purpose the furtherance of the "goal . . . to preserve the going-concern values of the debtor through an effective plan of reorganization". 6 COLLIER ON BANKRUPTCY ¶3.18, p. 547. As Congress recognized, the complex task of reorganizing a corporate debtor under Chapter X, and of seeking thereby "to preserve the going-concern values of the debtor", required an expanded federal jurisdiction, and it enacted Section 102 "to center jurisdiction in the federal courts to the exclusion of state tribunals" so long as the reorganization was going forward.[52] As Congress also recognized, however, such expanded federal jurisdiction would no longer be necessary or appropriate once it became apparent that the reorganization effort would be unsuccessful, and that bankruptcy and consequent liquidation of the debtor would have to proceed. Hence it expressly provided in Section 102 for a return to the normal jurisdictional pattern of Section 23, and the

[52] "The reason for a more extensive plenary jurisdiction in corporate reorganization [proceedings] is grounded in the very nature of the [proceedings] themselves. In ordinary bankruptcy, the requirements of liquidation were not thought sufficient to center jurisdiction in the federal courts to the exclusion of state tribunals. But in corporate reorganization, the [proceeding] normally affects all creditors and stockholders, all secured and unsecured claims, deals with all the debtor's property, and proceedings in other courts are largely overridden. The goal of the [proceeding] is to preserve the going-concern values of the debtor through an effective plan of reorganization. To accomplish this, expedition and centralization are essential factors. The public interest in securing speedy relief for financially embarrassed corporations is more important than considerations which would require the bringing of all plenary suits in state courts. To that end the reorganizaton court's concurrent jurisdiction to adjudicate plenary suits has been properly widened by the inapplicability of §23 *until and unless bankruptcy is proceeded with*" (emphasis added). 6 COLLIER ON BANKRUPTCY ¶3.18, pp. 547-548.

traditional Congressional preference reflected therein for State court adjudication of State law claims, as soon as "an order shall be entered [in the reorganization proceeding] that bankruptcy be proceeded with".

In drafting SIPA, and despite various references therein to Chapter X, Congress clearly intended that SIPA proceedings result in liquidation, rather than reorganization, of the broker-dealer involved, and recognized that there was thus no purpose in maintaining in SIPA liquidations the suspension of Section 23's jurisdictional limitations which Section 102 imposes in reorganization proceedings — just as there was no purpose in maintaining the suspension even in Chapter X reorganizations after it was directed that bankruptcy, and consequent liquidation, of the debtor should proceed. Thus, Congress expressly provided in Section 6(a)(4) of SIPA that the overriding purpose of a SIPA proceeding is "to liquidate the business of the debtor", and reiterated in Section 6(c)(1) itself that, despite the reference therein to Chapter X, "in no event shall a plan of reorganization be formulated". Congress then eliminated Section 102's suspension of the jurisdictional limitations of Section 23, by expressly providing in Section 6(c)(1) that SIPA proceedings were to be subject to such "provisions . . . of chapters I to VII . . . as [Section 102] would make applicable if an order of the court had been entered directing that bankruptcy be proceeded with". See, *e.g.*, *Securities and Exchange Commission* v. *Morgan Kennedy & Co.*, *supra*, CCH Fed.Sec.L.Rep. ¶94,568 at pp. 95,968-95,969 ("Congress . . . intended SIPA to be a statute whose dominant impulse is that of a liquidation and not a reorganization" and "Congress proposed that a SIPA proceeding be governed by the rules applicable to a liquidating reorganization under Chapter X", including the limitations on jurisdiction in Section 23 as made applicable by Section 102); 3 COLLIER ON BANKRUPTCY ¶60.86, p. 1252 ("the intention of [§6(c)] was to incorporate all the provisions of

Chapters I to VII which are not inconsistent with SIPA, including those enumerated sections in Section 102 which have no application to a Chapter X case unless bankruptcy ensues"); *Exchange Nat'l Bank* v. *Wyatt, supra*, 517 F.2d at 458-459 (reference provision of straight bankruptcy (§ 22), rather than reference provision of Chapter X (§ 117), is applicable in SIPA liquidation by virtue of Section 102, which is to be read as if liquidation has been ordered).[53]

4. THE EFFECT HERE OF SECTION 23. — Under Section 23, as Judge Wyatt correctly held, the District Court would have subject matter jurisdiction of the Trustee's common law "causes of action" only to the extent jurisdiction would have existed in an action between Weis itself and Touche Ross. However, as Judge Wyatt also correctly held, no diversity jurisdiction would have existed for such an action since both Weis and Touche Ross were citizens of New York (see p. 70 n. 48, *supra*), and therefore under Section 23 the District Court has no jurisdiction of the Trustee's common law "causes of action".

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[53] SIPC's own First Annual Report (1971) and Second Annual Report (1972) emphasize that "The [SIPA] proceeding is essentially a liquidation proceeding and the 1970 Act denominates it as such. In order to assure that only a liquidation will take place, Congress provided that, even though the proceeding is to be governed to a very large extent by those provisions of the Bankruptcy Act . . . relating to corporate reorganizations (Chapter X), in no event is a plan of reorganization to be formulated" (345a, 353a). Under Chapter X, after an order has been entered directing that bankruptcy be proceeded with, the proceeding goes forward "as far as possible as if no petition commencing a chapter [X] case had been filed". Bankruptcy Rule 122(1). Moreover, the powers of a SIPA trustee are set forth in SIPA itself (see p. 84 n. 61, *infra*). It would seem that SIPA's references to Chapter X are largely superfluous, a conclusion in fact reached by the SIPC Task Force which studied the operation of SIPA during its first four years and which proposed amending SIPA to eliminate any reference to Chapter X "since many of its provisions are inappropriate in the context of a liquidation." SIPC, *Report of the Special Task Force to Consider Possible Amendments to SIPA* (1974) (hereinafter the "*SIPC Task Force Report*") reprinted in Hearings before the Subcommittee on Consumer Protection and Finance, 94th Cong. 1st Sess., Serial No. 94-56 (hereinafter "Hearings") at 85 (1975).

B. Sections 5(b)(2) And 6(b)(1) Of SIPA Do Not Provide Jurisdiction For The Trustee's Common Law "Causes of Action", And There Is No "Additive Pattern" Of Jurisdiction.

The Trustee argues that Judge Wyatt ignored a so-called "additive pattern of all the jurisdictional provisions of SIPA", and asserts that Sections 5(b)(2) and 6(b)(1) of SIPA, 15 U.S.C. §§78eee(b)(2), 78fff(b)(1), confer on the District Court jurisdiction of his common law "causes of action" (Trustee Br. 29). The Trustee's contentions are erroneous. Not only do Sections 5(b)(2) and 6(c)(1) not confer such jurisdiction, but there is no such "additive pattern".

1. SECTION 5(b)(2). — The Trustee erroneously argues that jurisdiction of his common law "causes of action" is provided by the words — which he misleadingly takes out of context — of Section 5(b)(2) of SIPA, 15 U.S.C. §78eee(b)(2), that the court in a SIPA proceeding shall have the "powers * * * of a court of bankruptcy *and* of a court in a proceeding under Chapter X of the Bankruptcy Act" (Trustee Br. 29). The full sentence of Section 5(b)(2) from which the Trustee selectively quotes reads as follows (with the critical portion omitted by the Trustee set forth in italics):

> "Upon the filing of an application pursuant to subsection (a)(2) of this section, the court to which application is made shall have *exclusive jurisdiction of the debtor involved and its property wherever located* with the powers, to the extent consistent with the purposes of this act, of a court of bankruptcy and of a court in a proceeding under chapter X of the Bankruptcy Act" (emphasis added).

The italicized words make clear that this sentence of Section 5(b)(2) applies only to the *summary* jurisdiction of the bankruptcy judge over the debtor and his assets,

and is not a section providing plenary jurisdiction over actions against third persons. Although the legislative history does not discuss the sentence,[54] the sentence's language is familiar from the Bankruptcy Act, which has used language virtually identical to Section 5(b)(2)'s language of "exclusive jurisdiction of the debtor involved and its property wherever located" to confer jurisdiction in at least eight different places.[55] It is uniformly held that such language simply provides for the summary jurisdiction of a bankruptcy judge over the assets in the possession of the debtor, essentially a form of *in rem* jurisdiction.[56] Of course, it is well-settled that claims against third persons may not be adjudicated under the summary jurisdiction of the bankruptcy courts, but must be the subject of a plenary suit, *e.g.*, *Cline* v. *Kaplan*, 323 U.S. 97 (1944); *Taubel-Scott-Kitzmiller* v. *Fox*, 264 U.S. 426 (1924); *Kelley* v. *Gill*, 245 U.S. 116 (1917); *Harrison* v.

[54] The sentence did not appear in the original bill in the House of Representatives, H.R. 13308, 91st Cong., 2d Sess. The italicized words first appear, in identical form, in two bills presented to the House on successive days, one drafted by the SEC, H.R. 18081, 91st Cong., 2d Sess., §35(j)(3), the other by a group representing the securities industry, H.R. 18109, 91st Cong., 2d Sess., §36(a)(5). The final form of the quoted sentence emerged from the joint efforts of those same drafters. H.R. 18458, 91st Cong., 2d Sess., §35(m)(4). In addressing the liquidation provision of H.R. 18109, 91st Cong., 2d Sess., Ralph DeNunzio, Chairman of the industry group, declined to comment at length, stating only that the subject was "highly technical". Hearings before a Subcomm. of the House Comm. on Int. & For. Comm., 91st Cong., 2d Sess., Serial No. 91-67 at 167 (1970). From this, and from the simultaneous occurrence in two bills of the identical language, it can be inferred that the choice of language was intentional, not fortitious, and had reference to "technical" — *i.e.*, established — uses of the terminology. Hence the meaning given to the terms in the Bankruptcy Act, the source of the terminology, is relevant.

[55] Such language is used in Section 75(n), 11 U.S.C. §203(n) (farmer's relief); Section 77, 11 U.S.C. §205 (railroad reorganizations); Section 77B(a), Act of June 7, 1934, §77B(a), 48 Stat. 911, 912 (predecessor of Chapter X; now repealed); Section 82(a) of Chapter IX, 11 U.S.C. §402(a); Section 111 of Chapter X, 11 U.S.C. §511; Section 311 of Chapter XI, 11 U.S.C. §711; Section 411 of Chapter XII, 11 U.S.C. §811; and Section 611 of Chapter XIII, 11 U.S.C. §1011.

[56] *E.g.*, "[t]he grant of exclusive jurisdiction [in section 77B(a)] over the debtor and its property was not a departure from established

Chamberlin, 271 U.S. 191, 193-195 (1926),[57] and the cases recognize that the summary jurisdiction conferred by the "exclusive jurisdiction" language of the Bankruptcy Act sections referred to above does not extend to a power to adjudicate claims against third persons.[58]

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bankruptcy practice. The Bankruptcy Act . . . from the time of its enactment had conferred upon courts of bankruptcy exclusive jurisdiction over bankrupts and their property. . . . Congress did not intend to ignore the distinction theretofore recognized in the Bankruptcy Act between jurisdiction over persons and jurisdiction of property — between proceedings in personam and in rem — and that subdivision a of section 77B did not affect the existing jurisdiction of the bankruptcy courts over the former or conflict with the restrictions which section 23 placed upon that jurisdiction." *In re Standard Gas & Elec. Co.*, 119 F.2d 658, 661, 662 (3d Cir. 1941). See also, *e.g.*, *Continental Illinois Nat'l Bank & Trust* v. *Chicago, R.I. & Pac. Ry. Co.*, 294 U.S. 648, 681-684 (1935) (Section 77); *In re Prudence Bonds Corp.*, 75 F.2d 262 (2d Cir. 1935) (Section 77B(a)); *Thompson* v. *Terminal Shares*, 104 F.2d 1, 9 (8th Cir. 1939) (Section 77B(a)); *Mar-Tex Realization Corp.* v. *Wolfson*, 145 F.2d 360, 362-363 (2d Cir. 1944) (Section 111); *Duda* v. *Sterling Mfg. Co.*, 178 F.2d 428 (8th Cir. 1949) (Section 111); *Slenderella Systems of Berkeley, Inc.* v. *Pacific Tel. & Tel.*, 286 F.2d 488 (2d Cir. 1961) (Section 311); *In re Oliver*, 127 F.Supp. 842, 845-847 (D. Kan. 1955) (Section 611); *Tamasha Town & Country Club* v. *McAlester Constr. Fin. Corp.*, 252 F.Supp. 80, 85 and n. 1 (S.D. Cal. 1966) (Section 311).

[57] As this Court has stated, "an action to enforce a debt from the alleged debtor of the bankrupt, where the debtor denies the existence of the debt, is not within the summary jurisdiction", since in such cases the trustee "cannot claim possession, because the existence of the chose in action is the issue in dispute." *In re Eakin*, 154 F.2d 717, 719 (2d Cir. 1946). See also *In re Roman*, 23 F.2d 556, 558 (2d Cir. 1928) ("So far as possession can be imputed to such property at all, it is confined to the rights of the bankrupt to enforce the promise. . . . in a court having competent jurisdiction") (L. Hand, J.).

[58] See, *e.g.*, *Duda* v. *Sterling Mfg. Co.*, *supra* (jurisdiction under Section 111 does not extend to contract and other claims existing at time of filing of Chapter X petition); *Slenderella Systems of Berkeley* v. *Pacific Tel. & Tel. Co.*, *supra* (disputed contract claim not subject to Section 311 jurisdiction); *Tamasha Town & Country Club* v. *McAlester Constr. Fin. Corp.*, *supra* (damage action to enforce statutory penalty not within Section 311 jurisdiction); *In re Prudence Bonds Corp.*, *supra* (pledgee in possession not required to litigate the validity of his claim in summary proceeding under Section 77B(a)); *In re Standard Gas & Elec. Co.*, *supra* (trustee in Section 77B proceeding has no jurisdiction under Section 77B(a) to proceed summarily against parties alleged to have violated fiduciary duties to the debtor corporation).

Since Section 5(b)(2) uses precisely the same language as is found in the Bankruptcy Act, and since that language has been expressly held not to confer plenary jurisdiction over actions brought by a trustee against third persons, Section 5(b)(2) cannot properly be read to provide such jurisdiction over the Trustee's common law "causes of action". This has been plainly recognized in *Securities & Exchange Commission* v. *Morgan Kennedy & Co., supra,* CCH Fed.Sec.L.Rep. ¶94,568 at p. 95,971, where Bankruptcy Judge Babbitt held that Section 5(b)(2) did not provide any jurisdiction which would override the jurisdictional limitations imposed by Section 23 of the Bankruptcy Act, because:

> "Congress drafted SIPA to be read, where appropriate, in light of the rules pertaining to Chapter X, including broad powers to administer the debtor's assets. But this is not inconsistent with the application of liquidation rules, i.e., Section 23, where appropriate, to litigation arising during the liquidation. *Power over assets is one thing; power over disputes is another"* (emphasis added).

It is also significant that the Trustee does not rely upon Section 5(b)(2)'s language of "exclusive jurisdiction", but only upon its language about "powers". However, since Section 5(b)(2) does expressly use the word "jurisdiction", the use of the word "powers" obviously must refer to something else besides "jurisdiction".[59] The context demonstrates that it means "powers" with respect to the property over which the court has jurisdiction — *i.e.,* the power to use all the remedial devices a bankruptcy court or a Chapter X court might use to protect the debtor's property.[60] Thus, the "powers" language upon

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[59] See also discussion of the meaning of the word "power" in Section 115 of the Bankruptcy Act at pp. 86-89, *infra.*

[60] Given the purpose of SIPA to liquidate, not reorganize, the debtor, however, it is difficult to understand what those Chapter X powers might be. That difficulty suggests that the "powers" clause was added out of an excess of caution, perhaps to rebut the inference

which the Trustee relies does not show "additive" jurisdiction, as he would have it (Trustee Br. 29), but only "additive remedies."

Finally, it is to be noted that Section 5(b)(2) speaks of "exclusive jurisdiction", so that if the Trustee were correct in arguing that Section 5(b)(2) provides plenary jurisdiction here, it would mean that he could bring no action in any court other than the court in which the SIPA liquidation was proceeding and that his own State Court Action was improper. Certainly Congress did not intend the "exclusive jurisdiction" language to contract the powers of a trustee to pursue those indebted to the debtor's estate in other courts, and the Courts have not so read the statutory predecessors of Section 5(b)(2). See *Williams* v. *Austrian*, *supra* (Chapter X reorganization trustees may bring plenary suits in other districts); 6 COLLIER ON BANKRUPTCY ¶3.18, p. 539; *cf. Bardes* v. *Hawarden Bank*, *supra*, 178 U.S. at 532-33 (plenary jurisdiction is concurrent with, not exclusive of, state courts).

2. SECTION 6(b)(1). — The Trustee errs in suggesting that Section 6(b)(1) of SIPA has some relevance to

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that the specifications of powers of the SIPA court in the last three sentences of Section 5(b)(2) implied that the court should have no other powers. There is evidence, in the unsuccessful attempt to amend SIPA in 1975, that Section 5(b)(2)'s reference to Chapter X is surplusage. The proposed amendment arose out of recommendations suggested by SIPC's Board of Directors after the SIPC Task Force had investigated the inadequacies of SIPA (see p. 78 n. 53, *supra*), and would have changed Section 5(b)(2) so that the court with "exclusive jurisdiction of the debtor involved and its property wherever located" would have had "the jurisdiction, powers, and duties conferred upon a court of bankruptcy by the Bankruptcy Act, together with such other jurisdiction, powers, and duties as are prescribed by this Act." H.R. 8064 at 13, 94th Cong. 1st Sess. (1975) reprinted in Hearings at 14. Apparently SIPC, after conferring with "selected attorneys and accountants who had served as trustees or counsel", felt that the grant of powers under Chapter X was superfluous, and the Task Force (headed by SIPC's General Counsel) pointed out that proposed amendment did "not make significant substantive changes from SIPA as now in effect" and noted that many of Chapter X's provisions were "inappropriate in the context of a liquidation." *SIPC Task Force Report* reprinted in Hearings at 62, 85.

determining the District Court's jurisdiction (Trustee Br. 30). Section 6(b)(1) prescribes only the powers of a SIPA trustee, and has nothing to do with the jurisdiction of a district court.[61]

3. THE NON-EXISTENCE OF AN "ADDITIVE PATTERN" OF JURISDICTION. — Aside from the fact that neither Section 5(b)(2) nor Section 6(b)(1) confers plenary jurisdiction, it is nonsense for the Trustee to talk about the purported "additive pattern of all the jurisdictional provisions of SIPA" or about any such provisions conferring the "jurisdiction of both bankruptcy courts *and* Chapter X courts" (Trustee Br. 29). The purposes of Chapter X reorganizations and liquidations (whether in ordinary bankruptcy, or as a result of an order entered in a Chapter

[61] The Trustee apparently is attempting to argue that the language of Section 6(b)(1) shows a Congressional intention to blend all provisions of the Bankruptcy Act and Chapter X in SIPA proceedings. His argument is not persuasive, for the available evidence indicates that Section 6(b)(1)'s reference to Chapter X is superfluous. The legislative history speaks of a need for a trustee to have "reorganization powers" in order to run the debtor's business to complete open transactions and to deliver promptly cash and securities to customers. S.Rep. No. 91-1218, 91st Cong., 2d Sess. at 12 (1970); H.R.Rep. 91-1613, 91st Cong., 2d Sess., reprinted in 1970 U.S. Code Cong. & Adm. News 5254, 5264. But neither of those activities requires Chapter X powers, since SIPA itself provides a scheme for the prompt payment of customers, SIPA §§6(c)(2), (f), (g), 15 U.S.C. §§78fff(c)(2), (f), (g), and permits the trustee to complete "open contractual commitments", SIPA §6(d), 15 U.S.C. §78fff(d), and, to that end, to operate the business without court approval, SIPA, §6(b)(1)(B), 15 U.S.C. §78fff(b)(1)(B). The Bankruptcy Act, Chapters I—VII, would also suffice to provide at least some of those powers; for example, Section 2a(5), 11 U.S.C. §11a(5), permits the court to authorize the trustee in bankruptcy to conduct the business of the bankrupt for limited periods of time. There is, in short, no need for providing Chapter X powers in SIPA liquidations; accordingly, only limited weight can be given to Section 6(b)(1)'s mention of Chapter X. Again, as with Section 5(b)(2), the SIPC Task Force recommended the elimination of the incorporation of Chapter X into SIPA as "inappropriate in the context of a liquidation". *SIPC Task Force Report* reprinted in Hearings at 85, 88, and the amendments based on that report would have provided the SIPA trustee the same powers "as a trustee in bankruptcy under the Bankruptcy Act has with respect to the bankrupt." H.R. 8064, § 7(a), 94th Cong. 1st Sess., reprinted in Hearings at 28.

X proceeding, or pursuant to SIPA) are different, and the provisions (including the jurisdictional provisions) of Chapters I through VII are not necessarily consistent with the reorganization provisions of Chapter X. The principal inconsistency relevant here is, of course, the difference in the jurisdictional provisions — Section 23 being applicable in straight bankruptcy and inapplicable in Chapter X reorganizations. It would make no sense to try to "add" the two schemes together without analyzing how the inconsistencies should be resolved. The fact that there are such inconsistencies, and that it makes no sense to talk of merely adding all the pertinent provisions together, has been emphasized by SIPC itself.[62]

Moreover, the plenary jurisdiction in Chapter X reorganizations recognized in *Williams* v. *Austrian, supra,* although conferred by Section 2a(7) of the Bankruptcy Act, springs entirely from the effect of Section 102 of Chapter X. However, Section 102 provides for different results (including a different result as to whether Section 23 is applicable) depending upon whether a reorganization is in progress or whether a liquidation has been ordered. Thus it is necessary to know which of these two alternatives is applicable before Section 102 may be given effect. Section 6(c)(1) of SIPA answers precisely that question, since it states that Section 102 must be read as "if an order of the court had been entered directing that bankruptcy be proceeded with", with the result that Section 23 is always applicable in a SIPA liquidation. The Trustee, without stating any reason, tacitly assumes that precisely the contrary is true, and that Section 102 of

[62] See SIPC's First Annual Report (1971) and Second Annual Report (1972): "[T]here are conflicts between certain provisions of Chapters I through VII of the Bankruptcy Act and Chapter X of that Act. In addition, the major purpose of a Chapter X proceeding (the rehabilitation of the debtor) is inconsistent with one of the major purposes of a SIPC proceeding (the liquidation of the debtor), while certain provisions of Chapters I through VII which conflict with provisions of Chapter X are perfectly consistent with the purposes of a SIPC proceeding. SIPC is attempting to resolve these conflicts as they appear in any particular case" (345a, 353a).

Chapter X should be read as if a reorganization was being conducted. That assumption not only conflicts with the clear language of Section 6(c)(1) of SIPA, but also entirely disregards the fact that a SIPA proceeding is, as shown hereinabove, a liquidation and not a reorganization.

C. Section 115 Of The Bankruptcy Act Does Not Provide Jurisdiction For The Trustee's Common Law "Causes Of Action."

The Trustee points out that Section 6(c)(1) of SIPA incorporates Section 115 of the Bankruptcy Act (which, like Section 102, is part of Chapter X) and contends that Section 115 confers on the District Court here all the jurisdiction of a federal court supervising an equity receivership (Trustee Br. 31-35). That contention is erroneous.

Section 115 provides in pertinent part that

> "Upon the approval of a petition, the court shall have and may, in addition to the *jurisdiction, powers, and duties* hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the *powers*, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity" (emphasis added). 11 U.S.C. §515.

The Trustee's assertion that Section 115 is a grant of jurisdiction is simply not in accord with its language. Thus, Section 115 confers upon a Chapter X court only the "powers" of an equity receivership court, whereas in the same sentence it also speaks of the "jurisdiction, powers and duties" otherwise conferred. This clearly shows that Congress understood that the terms "powers" and "jurisdiction," in Section 115, signified separate and distinct concepts and compels the conclusion that Congress intended to confer only "powers" but not "jurisdiction".

See 6 COLLIER ON BANKRUPTCY ¶3.18, pp. 546-547 n.34 ("while §115 confers all the *powers* of an equity receivership court upon the reorganization court, it makes no reference to the jurisdiction of the equity receivership court").

In fact, the legislative history reveals a Congressional understanding that Section 115 does not constitute a jurisdictional grant, and an intention that it should not. Thus, an amendment to Section 115 which would have provided an express grant of equity receivership jurisdiction was introduced in the Senate and was rejected.[63]

Congress took the language of Section 115 from the virtually identical language of Section 77B(a) of the Bankruptcy Act, which has been enacted in the Corporate Reorganization Act of 1934.[64] It was uniformly held that Section 77B(a) did not create a grant of jurisdiction to the district courts and that, as this Court early concluded,

> "Congress did not intend the bankruptcy court in proceedings under section 77B to take over all litigation between the debtor and third persons." *In re Prudence Bonds Corp., supra,* 75 F.2d at 263 (L. Hand, J.).

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[63] Senator King, a member of the Judiciary Committee which reported on the Chandler Act, S. Rep. No. 1916, 75th Cong. 3d Sess. (1938), proposed an amendment on the Senate floor that, among other things, would have provided that "the jurisdiction, powers and duties of the court . . . shall be the same as in a proceeding in equity in a court of the United States in which a receiver of the debtor had been appointed on the ground of insolvency or inability to meet its debts as they mature." 83 Cong. Rec. 8708 (1938) (§129 of King amendment). The Senate rejected the amendment. *Id.* at 8728.

[64] In enacting Chapter X, "[b]y and large . . . the substance of section 77B is preserved" and "[s]ection 115 is derived from section 77B(a), with only minor changes in language." S. Rep. No. 1916, 75th Cong., 3d Sess. at 19, 24 (1938). Hence, decisions interpreting Section 77B(a) are applicable to Section 115.

Accord, United States v. *Tacoma Oriental S. S. Co.*, 86 F.2d 363, 368 (9th Cir. 1936); *In re Standard Gas & Elec. Co. supra* (§77B did not give juridiction to hear a trustee's plenary suit in federal district court).

Moreover, a consistent series of cases, occurring mostly in the Second Circuit, has interpreted the "powers" language of Section 115 and the predecessor language of Section 77B to mean the non-jurisdictional substantive powers over property exercised by a court of equity.[65] As the Third Circuit phrased it, with regard to Section 77B(a),

> "This reference to the powers which a federal equity court exercises when it appoints a receiver is to the substantive powers which such a court exercises over the property in its custody rather than to its jurisdiction to entertain plenary suits growing out of the receivership." *In re Standard Gas & Elec. Co., supra*, 119 F.2d at 662.

Accord, In re Prudence Co., 82 F.2d 755, 757 (2d Cir.), *cert. denied*, 298 U.S. 685 (1936); *In re Prima Co.*, 98

[65] Such "powers" have been held to include, for example, the power to determine priorities among claimants, *Reading Co.* v. *Brown*, 391 U.S. 471, 489 and n.6 (1968) (Warren, C. J., dissenting); *In re Yale Express Systems, Inc.*, 362 F.2d 111, 117 n.5 (2d Cir. 1966); *In re Chicago Express, Inc.*, 332 F.2d 276, 278 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964); *In re Hallmark Medical Services, Inc.*, 475 F.2d 801, 804 n.6 (5th Cir.), *cert. denied*, 414 U.S. 1003 (1973); *United States* v. *Anderson*, 334 F.2d 111, 115 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964); *In re Charles Nelson Co.*, 29 F.Supp. 56, 57 (N.D. Cal. 1939) (§77B(a)); *In re Sixty-Seven Wall St. Rest. Corp.*, 23 F.Supp. 672, 673 (S.D.N.Y. 1938) (§77B(a)); the power to sell perishable property, *In re V. Loewer's Gambrinus Brewery Co.*, 141 F.2d 747 (2d Cir. 1944); the power to settle claims against the debtor's estate, *In re Paramount Publix Corp.*, 7 F.Supp. 988 (S.D.N.Y. 1934) (§77B(a)); the power to allow or disallow interest on claims, *Vanston Committee* v. *Green*, 329 U.S. 156, 165 and n.8 (1946); and the power to consolidate several reorganizations into a single proceeding, 6 COLLIER ON BANKRUPTCY ¶3.17, p. 534; *In re Schafer's Bakeries*, 129 F.Supp. 82, 85 (E.D.Mich. 1955).

F.2d 952, 958 (7th Cir.), *cert. denied*, 305 U.S. 658 (1938).[66]

None of the cases cited by the Trustee (Trustee Br. 33) for the proposition that Section 115 is a grant of plenary jurisdiction so holds. One of those cases, *Williams* v. *Austrian, supra*, 331 U.S. at 659-661, found it unnecessary to reach the issue of whether Section 115 was jurisdictional because of its holding that, in light of Section 102's suspension of the limitations of Section 23 during reorganization, jurisdiction there existed by virtue of Section 2a(7). In the footnote referred to by the Trustee, the Supreme Court, after pointing out the decisions which hold the "powers" language of Section 77B and Section 115 to be "non-jurisdictional", cited two of the cases here cited by the Trustee as conflicting interpretations. Examination of those two cases (*Warder* v. *Brady* and *In re Cuyahoga Finance Co.*) shows, however, that even they did not hold that Section 115 is a grant of plenary jurisdiction.[67]

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[66] While the legislative history apparently has no discussion regarding the subject-matter jurisdiction of the federal courts in either the hearings or the debates on the Chandler Act, the importance of equitable remedies was emphasized. See Hearings before a Subcommittee of the Senate Comm. on the Judiciary on H.R. 8046, 75th Cong., 2d Sess. (1937-1938), Statement of John Gerdes, presenting amendments suggested by national bankruptcy conference, at 77 (priorities to be those in equity receiverships); Letter of Garrett Brownback at 205-206 (importance of flexible equitable remedies).

[67] The language in *Warder* v. *Brady*, 115 F.2d 89, 94 (4th Cir. 1940), regarding Section 115 is pure *dictum*. A special receiver had been *summarily* ordered to turn over money he held on behalf of bondholders; on appeal the Fourth Circuit mentioned in passing that it felt Section 115 might confer jurisdiction over a *plenary* suit, but reversed the order on the ground that the bankruptcy judge could not issue it *summarily*. Moreover, the Fourth Circuit discussed at greater length than it did Section 115 the effect of Section 102's suspension of the limitations of Section 23 on the jurisdiction granted by Section 2a(7), and it is unclear which statutory provision was regarded by the Court as essential to its analysis, Section 115 or Section 102.

In re Cuyahoga Finance Co., 136 F.2d 18, 20 (6th Cir. 1943), and the Trustee's other case, *In re Federal Facilities Realty Trust*, 220 F.2d 495, 499 (7th Cir. 1955), both dealt with the *summary* jurisdiction of a bankruptcy judge, and *not* with the *plenary* jurisdiction of a

Actually, it would have been superfluous for Congress to have vested Chapter X reorganization courts with the jurisdiction of an equity receivership court. As the Trustee points out, an equity receiver is only entitled to bring a plenary action in his "home court" (Trustee Br. 33-34). By virtue, however, of the jurisdiction provided by Section 2a(7), and Section 102's suspension of the limitations of Section 23 during a Chapter X reorganization, a Chapter X reorganization trustee can bring plenary actions in any district court where venue is proper and he can obtain personal jurisdiction. *Williams* v. *Austrian, supra,* 331 U.S. at 661; *Rochelle* v. *Marine Midland Grace Trust Co. of New York, supra; Magidson* v. *Duggan,* 180 F.2d 473, 476-477 (8th Cir.), *cert. denied,* 339 U.S. 965 (1950); 6 COLLIER ON BANKRUPTCY ¶3.18, p. 539.[68]

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district court, and thus are both in accord with the language quoted from *Standard Gas & Elec. Co., supra,* which held that Section 115's predecessor, Section 77B(a), only granted those "substantive powers which such a court exercises over the property in its custody"— *i.e., summary* jurisdiction. *Cuyahoga Finance* was an appeal of a *summary* turnover order granted against a pledgee in possession of the debtor's goods; the Sixth Circuit held that Section 115 supported that exercise of *summary* jurisdiction. *Federal Facilities Realty Trust* held that the bankruptcy judge's jurisdiction over the *res* provided *summary* jurisdiction over the trustee's claim to funds about to be distributed from the estate to employees whom the trustee had hired to perform tasks during the reorganization and for whose wrongful acts the trustee had been surcharged. Neither case dealt with the plenary jurisdiction of a district court to hear cases brought by a trustee. Both cases suffer from further weaknesses insofar as one might cite them as interpretations of Section 115. The Court in *Cuyahoga Finance,* like the *Warder* Court, never made clear whether it regarded jurisdiction to exist by reason of the addition of Section 115 or by reason of Section 102's suspension of the limitations of Section 23, and *Federal Facilities* only mentions Section 115 in passing in a single sentence that appears to have no bearing on the outcome of the case.

[68] The legislative history does not support the Trustee's argument that Section 115 was intended to provide plenary jurisdiction in the "home court". The language on which Section 115 is based first appeared in H.R. 5009, 73d Cong., 1st Sess., the immediate predecessor bill to the one enacted as Section 77B. See Friendly, *Some Comments on the Corporate Reorganizations Act,* 48 Harv. L. Rev. 39, 50-51 & n.45 (1934). The precise language added to H.R. 5009, which followed a grant of "exclusive jurisdiction of the debtor and its property wherever located," provided that the court "shall and may exercise all of the powers, not inconsistent with this section, which a federal court would have had if it appointed a receiver in equity of the

Finally, even if the "powers" language of Section 115 were assumed to be a grant of jurisdiction, Section 23 would limit that jurisdiction just as it limits jurisdiction under Section 2a(7). Like Section 2a(7), the "powers" provided for in Section 115 are those "not inconsistent with the provisions of this chapter". One of the provisions of "this chapter" is Section 102, which explicitly makes Section 23 applicable in the liquidation context present here. It makes more than linguistic sense for Section 115, assuming it grants jurisdiction, to be subordinate to Section 23. As already indicated, when a court order terminates a Chapter X reorganization and initiates liquidation, the trustee has no more need than any other bankruptcy trustee for the broad plenary jurisdiction of the reorganization courts. Whether that plenary jurisdiction were to derive from Section 2a(7) or Section 115 cannot alter its cessation with liquidation. See 6 COLLIER ON BANKRUPTCY ¶3.18, pp. 544-45. Nor can it be that somehow Section 115, because of some inherent quality that distinguishes it from Section 2a(7), escapes the effect of Section 23. Cases decided under Section 77B make this clear. Acting through Section 77B(o) which, to the extent

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property of the debtor on the ground of insolvency." The sponsor of the bill, Representative McKeown, explained the reason:

> "Now that is a change in the language [from earlier corporate reorganization bills] for the reason: It seems that in the case of *Phipps* v. *Chicago* (284 Fed. Rep.), that decision suggested the advisability of conferring upon the court the power of Federal courts in equity jurisdiction." Statement of Rep. McKeown, Hearings before House Jud. Comm. on H.R. 1670, H.R. 3083, H.R. 4311, H.R. 5267 and H.R. 5009, 73d Cong. 1st Sess. at 188 (1933).

The case which Rep. McKeown cited, *Phipps* v. *Chicago, R.I.&P. Ry. Co.*, 284 Fed. 945 (8th Cir. 1922), had nothing to do with the "home court" jurisdiction of the federal district court in an equity receivership, but concerned only the equitable powers of the bankruptcy court, usually exercised in summary proceedings, to control, protect and transfer the debtor's property. There is not the slightest indication in either the *Phipps* case or Rep. McKeown's comment to suggest that the statutory language now set forth in Section 115 intended to confer anything more than such powers on a reorganization court.

consistent with Section 77B, made the "jurisdiction . . . [of] the court . . . the same" as in bankruptcy and hence incorporated Section 23, *e.g., In re Standard Gas & Electric Co., supra,* 119 F. 2d at 660-663, Section 23 was always held to control jurisdiction under Section 77B, despite the presence there of the predecessor language to Section 115. *Tilton* v. *Model Taxi Corp.*, 112 F.2d 86, 88 (2d Cir. 1940); *In re Prima Co., supra,* 98 F.2d at 958 (the predecessor language to Section 115 did not "amount to a repeal by implication of Section 23").

It is nonsense for the Trustee to argue that Section 23 does not limit whatever jurisdiction may be provided by Section 115, a provision of Chapter X, because Section 6(c)(1)'s language (*viz.*, a SIPA liquidation is to be conducted in accordance with "the provisions of Chapter X and such of the provisions . . . of Chapters I to VII . . . as Section 102 would make applicable") refers to Chapter X before it refers to Chapters I to VII and Section 102 (Trustee Br. 31-32). The Trustee's contention would simply ignore the fact that the conjunction "and"—as in the phrase "the provisions of Chapter X *and* such of the provisions . . . of Chapters I to VII"—joins and does not subordinate. Moreover, the Trustee's construction of Section 6(c)(1) presumes that Section 102 is somehow separate and distinct from Chapter X, of which it is, in fact, an integral part. In making the provisions of Chapter X applicable to SIPA liquidations, Congress necessarily made Section 102 applicable as well—and, of course, Section 102 not only makes applicable certain specified provisions (including Section 23) upon entry of the order to proceed in bankruptcy, but also without any order incorporates much of Chapters I-VII automatically. Section 102 is referred to separately in Section 6(c)(1) in order to clarify that it and indeed all of Chapter X is to be read as if an order directing liquidation had been entered.

Thus, Section 115 does not confer the "home court" or any other plenary jurisdiction of an equity receiv-

ership[69]—and even if it did, under SIPA Section 23 would control that jurisdiction—and the cases cited by the Trustee which involve the equity receivership jurisdiction are irrelevant here.

D. Touche Ross Did Not Consent To Plenary Jurisdiction Here By Filing Proofs Of Claim.

The Trustee contends that Touche Ross consented to the District Court's jurisdiction over his common law "causes of action" by filing two proofs of claim in the Weis liquidation proceeding on July 10, 1973 (Trustee Br. 36-42). The Trustee's contention, which Judge Wyatt rejected (409a-410a), is erroneous for at least two reasons. First, the filing of a proof of claim, without further indication of consent, is insufficient to confer jurisdiction in a plenary action. Second, even if it were assumed *arguendo* that consent to jurisdiction in a plenary action could be inferred from filing a proof of claim, there would be no jurisdiction here because Touche Ross' proofs of claim would not have conferred jurisdiction of the Trustee's claims even in a summary proceeding.

1. THE PROOFS OF CLAIM DO NOT CONFER JURISDICTION IN THIS PLENARY ACTION—Section 23 of the Bankruptcy Act, which is applicable in every SIPA liquidation, and which the Trustee concedes to be applicable for purposes of his consent argument (Trustee Br. 36-37), was enacted to limit the broad grant of jurisdiction conferred on district courts in plenary proceedings by Section 2a of the Bankruptcy Act and its antecedents (see pp. 70-71, *supra*). Section 23 also contains a provision

[69] It is doubtful that Section 115 or any provision of the Chandler Act was intended to keep alive equity receiverships. As Representative Chandler, the sponsor of the bill, explained to the Senate Committee on the Judiciary, he and the other drafters "endeavored, as far as possible, to get rid of receivership proceedings." Statement of Rep. Chandler, Hearings before a Subcommittee of the Senate Comm. on the Judiciary on H.R. 8046, 75th Cong. 2d Sess. at 4 (1937-1938).

which authorizes federal jurisdiction "by consent of the defendant".[70] The provision regarding consent was included as a concession to the defendant who "might not object to—indeed would welcome—federal court jurisdiction." *Tenenbaum* v. *Walter E. Heller & Co.*, 308 F.Supp. 1085, 1087 n.9 (S.D.N.Y. 1970) (Weinfeld, J.) (citing remarks of Senator Lindsay at 30 Cong. Rec. 601-602 (1897)).

The filing of a proof of claim does not constitute consent to *plenary* jurisdiction under Section 23. As the Tenth Circuit has unequivocally stated,

> "[a] claimant does not consent to the exercise of the bankruptcy court's plenary jurisdiction by filing his claim in the bankruptcy proceedings." *Katchen* v. *Landy*, 336 F.2d 535, 537 (10th Cir. 1964), *aff'd*, 382 U.S. 323 (1966).

Although summary jurisdiction may be exercised on the basis of consent inferred from acts of a claimant (*e.g.*, the act of filing a proof of claim), plenary jurisdiction may not be exercised on such a basis. *Tamasha Town & Country Club* v. *McAlester Const. Fin. Corp.*, *supra*, 252 F.Supp. at 89. The reasons of judicial economy (see pp. 97-98, *infra*) which justify treating the act of filing a proof of claim as a consent by the claimant to summary jurisdiction of certain counterclaims of the trustee are simply inapplicable where the trustee, instead of asserting a counterclaim in the liquidation proceeding itself, asserts his claim in a separate plenary action. As the Court in *Tamasha Town & Country Club* put it,

> "the policy underlying the doctrine of consent to summary jurisdiction by acts of the claimant, is

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[70] Section 23 is clearly jurisdictional. The parenthetical comment in *Chase Nat'l Bank* v. *Lyford*, 147 F2d 273, 277 (2d Cir. 1945) that Section 23 relates "not to 'jurisdiction' but to venue," a comment relied upon by the Trustee (Trustee Br. 39), apparently overlooked the Supreme Court's explicit rejection of that reading of Section 23 eleven years earlier in *Schumacher* v. *Beeler*, *supra*, 293 U.S. at 371. See also *Tenenbaum* v. *Walter E. Heller & Co.*, 308 F. Supp. 1085, 1086-1087 (S.D.N.Y. 1970).

avoiding multiplicity of actions and permitting the casting of accounts between the parties. Neither of these would be advanced by extending the doctrine of consent by acts of the claimant to a plenary proceeding." 252 F.Supp. at 89.

The type of consent which is necessary to support plenary jurisdiction under Section 23 is express consent by the defendant to the jurisdiction of the district court over the plenary action or consent by the defendant's pleading to the merits in the plenary action without objection to jurisdiction. 2 COLLIER ON BANKRUPTCY ¶23.14, p. 602.[71] But where defendant makes no answer on the merits and expressly objects to jurisdiction by moving to dismiss the action for lack of subject matter jurisdiction, no consent exists or may be implied under Section 23. *Halpert* v. *Engine Air Service*, 116 F.Supp. 13, 15 (E.D.N.Y. 1953); see *Stiefel* v. *14th Street & Broadway Realty Corp.*, 48 F.2d 1041, 1043 (2d Cir. 1931). Of course, Touche Ross here has not given any express consent to jurisdiction, has not answered on the merits, and has moved to dismiss for,

[71] Courts have found consent to plenary jurisdiction in a general appearance and a plea on the merits, *Schumacher* v. *Beeler*, *supra*, 293 U.S. at 369 (declining to permit party, after these steps, to withdraw consent and contest jurisdiction); explicit admissions of jurisdiction and litigation on the merits, *Gins* v. *Mauser Plumbing Supply Co.*, 148 F.2d 974, 977 n.5 (2d Cir. 1945); a specific concession of jurisdiction and litigation on the merits, *Tilton* v. *Model Taxi Corp.*, *supra*, 112 F.2d at 88; litigation on the merits and a failure to object to jurisdiction, *Toledo Fence & Post Co.* v. *Lyons*, 290 Fed. 637, 639-640 (6th Cir. 1923); *In re Prima Co.*, *supra*, 98 F.2d at 959 (7th Cir. 1938); a stipulation that the court had jurisdiction, *Green* v. *Gage*, 186 F.2d 984, 986-987 (5th Cir. 1951); pleading to the merits and taking testimony, *Detroit Trust Co.* v. *Pontiac Savings Bank*, 196 Fed. 29, 31-32 (6th Cir. 1912), *aff'd*, 237 U.S. 186 (1915); answering on the merits or appearing in court to seek affirmative relief, *May* v. *Moss*, 194 F.2d 133, 137 (8th Cir.), *cert. denied*, 343 U.S. 952 (1952); and appearing, pleading to the merits, affirmatively requesting relief and litigating the merits at trial and on appeal, *Wymard* v. *McCloskey & Co.*, 342 F.2d 495, 497-498 (3d Cir.) (en banc), *cert. denied*, 382 U.S. 823 (1965) (3 judges dissented, taking the position that under the circumstances even these facts did not suffice to show consent to jurisdiction).

inter alia, lack of subject matter jurisdiction; in short, Touche Ross has not welcomed this action, commenced as it was on top of the identical State Court Action, and has done its utmost to express its lack of consent to jurisdiction.

None of the cases cited by the Trustee (Trustee Br. 39-40) supports his theory that a creditor, who by filing a proof of claim implicitly consents to summary jurisdiction of certain of the trustee's counterclaims, also thereby consents to the court's jurisdiction of an entirely separate plenary action commenced by the trustee based on those claims. *Chase Nat'l Bank* v. *Lyford, supra,* held only that by filing a proof of claim, claimant consented to summary jurisdiction of a related counterclaim and could not insist on a plenary action with respect thereto (see also p. 94 n. 70, *supra*). *Whitney* v. *Wenman,* 198 U.S. 539 (1905), which is the basis for the Trustee's quotation from Professor Moore's treatise (Trustee Br. 39), did not involve the issue of consent jurisdiction, but held merely that under Section 2a the trustee could bring a plenary action (even though summary jurisdiction also would have existed) to compel defendants to return property which had been in the possession of receivers (and hence constructively in possession of the Court) but which the receivers, without authority, gave to defendants. See *Schumacher* v. *Beeler, supra,* 293 U.S. at 370 and n. 2. *Whitney* was thus a case where for substantive reasons both summary *and* plenary jurisdiction over the subject matter were conferred by the Bankruptcy Act; it does not in any way assert that where, solely for reasons of judicial economy, summary jurisdiction might exist with respect to a claim of the trustee simply because it is asserted as a counterclaim to a creditor's claim in the liquidation proceeding, the trustee can — in derogation of the very reason for implying such jurisdiction in the first place — assert his claim in a

separate plenary action. Moreover, the other cases cited by the Trustee (Trustee Br. 40 n. 13) do not stand for the proposition, as the Trustee apparently would suggest, that where there is summary jurisdiction, one ought, to avoid criticism, proceed plenarily.[72]

2. THE PROOFS OF CLAIM WOULD NOT CONFER JURISDICTION EVEN IN A SUMMARY PROCEEDING. — It is also clear that the filing of Touche Ross' proofs of claim would not have conferred jurisdiction over the Trustee's common law "causes of action" even if he asserted them as counterclaims in a summary proceeding. It is for reasons of judicial economy that courts have been willing to consider the act of filing a proof of claim as consent to counterclaims by the trustee, where the claim and counterclaim are "so closely related [that] it is unreasonable . . . to separate one from the other." *Continental Casualty Co.* v. *White*, 269 F.2d 213, 215 (4th Cir. 1959). See also *Peters* v. *Lines*, 275 F.2d 919 (9th Cir. 1960) (creditor claimed damages for breach of contract; trustee permitted to counterclaim for breach of same contract).[73] Accord-

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[72] *In re Herz Importing Corp.*, 349 F.Supp. 1106 (S.D.N.Y. 1972), simply held that the bankruptcy judge did not have summary jurisdiction over the property in question, an insurance policy, and hence "the trustee's claim must be adjudicated in a plenary suit, not a summary proceeding." *Id.* at 1107. Nothing was said about what court would have jurisdiction of that plenary suit. *In re Ira Haupt & Co.*, 289 F.Supp. 966 (S.D.N.Y. 1968), held only that a claimant, having consented to summary jurisdiction, could not then assert any right to a plenary action on a trustee's counterclaim. The Court, quoting the bankruptcy judge, accused the *claimant* of trying to "have its cake and eat it, too". *Id.* at 972. In *In re Wonderbowl, Inc.*, 456 F.2d 954, 956 (9th Cir. 1972), the trustee had commenced *both* summary and plenary actions against Caruso Enterprises; Caruso apparently raised no objection to jurisdiction in either forum. Caruso moved to stay the summary proceeding while the plenary action was in progress; the Ninth Circuit reversed the bankruptcy judge's denial of that motion. The Ninth Circuit held that where both forms of jurisdiction are available, plenary actions are preferable in complex cases.

[73] This prevents the trustee from having to present the same evidence twice, once before the bankruptcy judge to defend against the creditor's claim and once before the court with plenary jurisdiction to make his affirmative recovery. See *In re Farrell Publishing Co.*, 130 F.Supp. 449, 453 (S.D.N.Y. 1955) ("The same proof will be

ingly it is well-established that the filing of a proof of claim will only confer summary jurisdiction as to claims by a trustee which involve preferences or voidable liens or transfers, or which arise out of the same transaction for which recovery is sought in the proofs of claim and are so intimately related to the original claims as to be compulsory counterclaims.[74] See, *e.g.*, *Peters* v. *Lines*, *supra*, 275 F.2d at 925; *In re Behring & Behring*, 445 F.2d 1096, 1098 (5th Cir.), *cert. denied*, 404 U.S. 991 (1971) ("The district court . . . held that the subject matter of the counterclaim was not so inextricably interwoven with the subject matter of the claim . . . as to be brought under the summary jurisdiction of the Bankruptcy Court. We agree").[75] The relationship between claim and counter-

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required in defending against [the creditor's] claim as is necessary in the proof of the trustee's counterclaim"); *Columbia Foundry Co.* v. *Lochner*, 179 F.2d 630, 633 (4th Cir. 1950) ("creditor must produce the same evidence to save his claim as he would to defeat an affirmative judgment against him on the counterclaim"). Moreover, once the bankruptcy judge adjudicates the creditor's claim, principles of collateral estoppel would prevent relitigation of some if not all of the issues in the trustee's closely related counterclaim, so that requiring the trustee to bring a separate plenary action against the claimant to litigate a matter already settled between them would be to exalt form over substance. Cf. *Katchen* v. *Landy*, 382 U.S. 323, 333-335 (1966). See also *Giffin* v. *Vought*, 175 F.2d 186, 189-190 (2d Cir. 1949).

[74] Since the summary jurisdiction of the bankruptcy judge abrogates the claimant's right to trial by jury which he would have if he had not filed a claim but rather abided the trustee's plenary suit, *Katchen* v. *Landy*, 382 U.S. 323, 336-340 (1966), a right normally entitled to great deference, *Beacon Theatres* v. *Westover*, 359 U.S. 500, 510-11 (1959) (right to jury trial lost "only under the most imperative circumstances"), courts have been very cautious in enlarging that jurisdiction. See *In re Behring & Behring*, *supra*, 445 F.2d at 1098-1099; *Gill* v. *Phillips*, 337 F.2d 258, 262-263 (5th Cir. 1964); *In re Carnell Constr. Corp.*, 424 F.2d 296, 298 (3d Cir.), *cert. denied*, 400 U.S. 828 (1970); *In re Beasley-Gilbert's, Inc.*, 285 F.Supp. 359, 363 (S.D. Ohio 1968); Ferguson, *The Consensual Basis of Subject-Matter Jurisdiction in Matters of Bankruptcy: Fact and Fiction*, 14 Rutgers L. Rev. 491, 493, 511 (1959).

[75] See also *In re Carnell Constr. Corp.*, *supra*, 424 F.2d at 298-299 (3d Cir. 1970) (bank claimed security interest in debtor's automobile; no jurisdiction over counterclaim regarding other loan of debtor which bank had set off against funds deposited with it); *In re Los Angeles Trust Deed & Mtge. Exch.*, 464 F.2d 1136, 1138-1139

claim required to confer consent jurisdiction is evident from *Behring, supra,* where the creditor filed a proof of claim alleging that it purchased cotton from the debtor which was not delivered. The trustee counterclaimed for alleged usurious interest paid to the creditor. The creditor moved to dismiss the counterclaim on the ground that the transactions which formed the basis for the counterclaim were entirely separate from those upon which the proof of claim was based. The trustee argued that the transactions were not discrete since his relationship with the creditor constituted a "continuing financing arrangement". 445 F.2d at 1098. The Fifth Circuit, rejecting the trustee's request to adopt a permissive counterclaim standard, found that "each transaction was a separate and severable agreement, and not contingent on any other transaction, past or future, between the parties." 445 F.2d at 1099.[76]

(9th Cir.), *cert. denied,* 409 U.S. 1064 (1972) (creditors asserted claims with regard to parcels of land; *held:* no summary jurisdiction over counterclaims regarding other parcels); *In re Majestic Radio & Television Corp.,* 227 F.2d 152 (7th Cir. 1955), *cert. denied,* 350 U.S. 995 (1956) (creditor's claim for goods sold did not subject him to summary jurisdiction regarding breaches of fiduciary duty as director); *In re Supreme Meat Co.,* 73 F.R.D. 295 (E.D. Mo. 1976) (insuror's claim for premium under one policy did not subject him to summary jurisdiction of counterclaim for payment pursuant to prior policy); *In re Beasley-Gilbert's, Inc., supra,* (creditor filed claims for rent and under guaranty agreement; *held* not to have consented to summary jurisdiction over counterclaim under contract to purchase shares of stock); see also *Daniel* v. *Guaranty Trust Co.,* 285 U.S. 154 (1932); *Katchen* v. *Landy, supra,* 336 F.2d at 537; *Cherno* v. *Engine Air Service, Inc.,* 330 F.2d 191, 193 (2d Cir. 1964). These cases show that the Trustee errs in asserting that only a "diluted version" of the compulsory counterclaim standard is applicable (Trustee Br. 37), or that mere "overlapping" proof is sufficient (*id.* at 38).

[76] The Trustee's cases (Trustee Br. 37-39) hold no differently. *Nortex Trading Corp.* v. *Newfield,* 311 F.2d 163 (2d Cir. 1962), involved a counterclaim for recovery of a preference. *In re Farrell Publishing Corp., supra,* 130 F.Supp. at 452, defined "related claims" as those "arising out of the subject matter of the creditor's claim" and in fact applied the compulsory counterclaim standard. In *Chase Nat'l Bank* v. *Lyford,* 147 F.2d 273 (2d Cir. 1945), the bank had set off funds in the bankrupt's account against part of its claim, and the trustee's counterclaim challenged that set-off. *In re Seatrade Corp.,* 297 F.Supp. 577 (S.D.N.Y. 1969), held that a compulsory counterclaim standard was applicable; its comment that there appeared to be

The Trustee's common law "causes of action" do not involve a preference or voidable transfer and do not arise out of the same transaction for which Touche Ross seeks compensation in its proofs of claim. The Trustee sues Touche Ross with respect to services in connection with various financial statements which were examined "as of May 26, 1972" (Comp. ¶ 24). In its proof of claim, however, Touche Ross seeks reimbursement for work which was performed after the examination of those financial statements, including services performed on behalf of certain European offices of Weis in late 1972, and auditing work and related services performed in or about April 1973. The complaint raises no issue whatsoever about the adequacy of the services covered by the proofs of claim, and there is no merit to the Trustee's contention that the two distinct sets of services were substantively connected.[77]

"no good reason" to bar permissive counterclaims is simply erroneous *dictum* (see also p. 98 n. 74, *supra*). *Alexander* v. *Hillman*, 296 U.S. 222 (1935), is of dubious authority since it involved equity receivership rather than bankruptcy, see *In re Majestic Radio & Television Corp.*, *supra*, 227 F.2d at 156; *In re Behring & Behring*, *supra*, 445 F.2d at 1099, and no court has ever read that case as supporting implied consent bankruptcy jurisdiction of unrelated counterclaims.

[77] The Trustee's cases (Trustee Br. 40-41) are not on point. The decision in *Goldberg* v. *Touche Ross & Co.*, summarized at CCH Fed. Sec. L. Rep. ¶95,759 (S.D.N.Y. 1976), holds that workpapers of a later audit are discoverable in a suit based on an earlier one because they "may lead to some evidentiary discoveries." This possibility of relevance hardly establishes that claims based on two audits, one being the creditor's claim for payment for the later audit, the other being the Trustee's counterclaim for negligent performance of the earlier audit, are so interrelated that they ought to be litigated in a single proceeding. *Wilkin* v. *Dana R. Pickup & Co.*, 74 Misc.2d 1025, 347 N.Y.S.2d 122 (Sup. Ct. Allegany County 1973), deals solely with the state statute of limitations for accountant's malpractice and does not purport to substantively join discrete transactions for purposes of determining whether counterclaims are compulsory counterclaims. *Fischer* v. *Kletz*, 266 F.Supp. 181 (S.D.N.Y. 1967), and *Bancroft* v. *Indemnity Ins. Co.*, 203 F.Supp. 49, 55 (W.D. La.), *aff'd*, 309 F.2d 959 (5th Cir. 1962), concern the duty to correct previous auditors' opinions upon later discovery that they are misleading. The Trustee

V

If The Order Of The District Court Is Reversed In Any Respect, This Action Should Be Stayed Pending Determination Of The State Court Action

It was unnecessary for Judge Wyatt to reach the issue of whether this action should be stayed pending determination of the State Court Action. However, if Judge Wyatt's order is reversed in any respect this Court can and should decide the issue and direct that this action be so stayed.[78] Plaintiffs' allegations of negligence and malpractice are (despite the grafting of references to Section 17 in the complaint here) the crux of all their claims against Touche Ross and present State law issues which should properly be dealt with in the State Court Action, which was begun nearly ten months earlier than this action, which involves the same parties, allegations, common law claims and prayers for relief, and in which discovery is now proceeding. It would be inappropriate to burden the federal court and Touche Ross with this second action which would proceed full tilt along a parallel track.

The inherent power to grant the stay cannot be questioned. *E.g., Mottolese* v. *Kaufman,* 176 F.2d 301 (2d

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has not alleged that Touche Ross discovered the frauds of the Weis Five in performing the accounting services for which the proofs of claim seek payment and then failed to reveal them. Hence, *Fischer* and *Bancroft* are inapposite. The Trustee also errs in emphasizing that one proof of claim is an "apparent priority claim" for administrative expense, since such claims are deemed "unrelated" to pre-bankruptcy claims asserted by a trustee. *Cherno* v. *Engine Air Service, Inc., supra,* 330 F.2d at 193; cf. *M'Eldowney* v. *Card,* 193 Fed. 475, 480-481 (E.D. Tenn. 1911).

[78] It would be appropriate for this Court to decide the issue because it is in as good a position to make such determination as is the District Court, *e.g., William B. Tanner Co., Inc.* v. *WIOO, Inc.,* 528 F.2d 262, 269 (3d Cir. 1975), and judicial economy would better be served by an immediate determination rather than a remand, *e.g., Smith* v. *Government of Virgin Islands,* 329 F.2d 135, 142 (3d Cir. 1964), particularly since the issue is procedural, *cf., e.g., Locke* v. *Bd. of Public Instruction,* 499 F.2d 359 (5th Cir. 1974); *Caldwell* v. *Craighead,* 432 F.2d 213, 216 (6th Cir. 1970).

Cir. 1949). Moreover, it is clear that a federal action should be stayed pending determination of a parallel State court action, even though plaintiff has managed to aver some cause of action within the exclusive jurisdiction of the federal courts, where there is (as here) a reasonable likelihood that resolution of the State Court Action will decide the federal action as well. See *Klein* v. *Walston & Co.*, 432 F.2d 936 (2d Cir. 1970); *Brummer* v. *Rosenberg*, CCH Fed.Sec.L.Rep. ¶92,341 at p. 97,626 (S.D.N.Y. 1969); *Finkelstein* v. *Wolf*, CCH Fed.Sec.L.Rep. ¶94,885 (S.D.N.Y. 1974).[79]

The complex of factors in the present situation is compelling that if Judge Wyatt's order is reversed in any respect, this action should be stayed pending resolution of the State Court Action:

(a) "The federal complaint is virtually a carbon copy of the . . . state complaint", and staying this action would be in the interests of judicial economy and conservation of litigant resources. See, *e.g.*, *Weiner* v. *Shearson, Hammill & Co.*, 521 F.2d 817, 821 (9th Cir. 1975).

(b) A judgment in the State action will be dispositive of the significant issues here. See *Klein* v. *Walston & Co.*, *supra*; *Paskowski* v. *Paskowski*, 351 F. Supp. 981, 982-983 (E.D.N.Y. 1973).

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[79] In *Klein*, this Court affirmed the stay of a Federal action asserting claims under the 1934 Act as well as common law contract and fraud claims, because the issues to be resolved in the parallel State court action "may be dispositive of the 1934 Act claims as well." 432 F.2d at 937. Here, of course, a resolution of the State law claims for negligence and malpractice would unquestionably dispose of any Federal action: a decision that Touche Ross was liable for negligence and malpractice would leave plaintiffs with no need to seek a second verdict in Federal court, and a decision that Touche Ross was not liable even for negligence and malpractice would almost surely result in collateral estoppel of any claim under Section 17, which necessarily would require proof of every element of malpractice plus additional elements such as *scienter* (see pp. 64-67, *supra*).

(c) Plaintiffs' prosecution of two suits would needlessly burden Touche Ross and the Federal court. A "litigant is entitled to his day in one court, but not in two". *Rosenfeld* v. *Black*, 445 F.2d 1337, 1341 n.5 (2d Cir. 1971).

(d) The parties to both actions are identical. "This is not the case of a stay operating to delay the prosecution of a cause of action by a stranger to [the State Court Action]" who would be foreclosed from litigation pending the state proceedings. *Brummer* v. *Rosenberg, supra*, CCH Fed.Sec.L.Rep. ¶92,341 at p. 97,627.

(e) Effective relief can be rendered in the State Court Action. See, *e.g.*, *Witmar Salvage Corp.* v. *C. W. Blakeslee & Sons, Inc.*, 308 F.Supp. 395 (S.D.N.Y. 1969).

(f) If Judge Wyatt's order were reversed in favor of only one of plaintiffs, the State Court Action would be the only forum for determining in one Court the claims of both plaintiffs.

(g) Perhaps most important of all, the pretrial proceedings and trial will necessarily revolve around the common law negligence and malpractice claims which are more appropriately to be decided by the State court.

Conclusion

For the foregoing reasons, the order and judgment appealed from should be affirmed.

Respectfully submitted,

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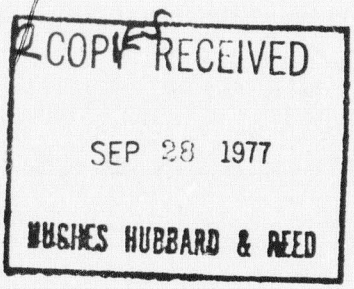

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